REPORTS
OF THE
UNITED STATES TAX COURT

July 1, 1985, to December 31, 1985
Volume 85

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MARY T. PITTMAN
REPORTER OF DECISIONS

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ERRATUM

83 T.C. at 582–583 (*Graham v. Commissioner*):

In the *Graham* slip opinion, page references were made to the *Church of Scientology of California* slip opinion. In changing page references from the pagination in the slip opinion to the pagination in the printed opinion, incorrect page numbers were printed.

On page 582, in footnote 10, line 2, "83 T.C. at 447–454." should read "83 T.C. at 460–465." Footnote 10 should read as follows:

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[10] Petitioners raise similar establishment clause arguments in *Church of Scientology of California v. Commissioner*, 83 T.C. at 460–465. While that case dealt with the constitutionality of sec. 501(c)(3), its rationale is fully applicable to sec. 170 and we incorporate herein by this reference that portion of the opinion.

On page 583, in footnote 11, line 2, "83 T.C. at 453–454." should read "83 T.C. at 447–454." Footnote 11 should read as follows:

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[11] This issue of selective enforcement was also raised and rejected in *Church of Scientology of California v. Commissioner*, 83 T.C. at 447–454.

JUDGES OF THE UNITED STATES TAX COURT

Chief Judge

Samuel B. Sterrett

Judges

Charles R. Simpson
William A. Goffe
Richard C. Wilbur
Herbert L. Chabot
Arthur L. Nims III
Edna G. Parker
Meade Whitaker
Jules G. Körner III
Perry Shields
Lapsley W. Hamblen, Jr.
Mary Ann Cohen
Charles E. Clapp II
Stephen J. Swift
Julian I. Jacobs
Joel Gerber
Lawrence A. Wright
Carolyn Miller Parr[1]
B. John Williams, Jr.[2]

Senior judges recalled to perform judicial duties under the provisions of section 7447 of the Internal Revenue Code of 1954:

Arnold Raum
William M. Drennen
Irene F. Scott
Theodore Tannenwald, Jr.
C. Moxley Featherston
Darrell D. Wiles
William M. Fay
Howard A. Dawson, Jr.

Special Trial Judges

John J. Pajak, *Chief Special Trial Judge*

James M. Gussis
Francis J. Cantrel
Daniel J. Dinan
Marvin F. Peterson
Fred R. Tansill
Randolph F. Caldwell, Jr.[3]
Lee M. Galloway
Helen A. Buckley
Peter J. Panuthos
Joan Seitz Pate
Hu S. Vandervort
Lehman C. Aarons
D. Irvin Couvillion[4]
Norman H. Wolfe[5]
Stanley J. Goldberg[6]
Carleton D. Powell[7]

Charles S. Casazza, *Clerk*

Paul Nejelski, *Court Administrator*

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[1] Judge Parr took oath of office November 25, 1985.
[2] Judge Williams took oath of office December 2, 1985.
[3] Resigned August 31, 1985.
[4] Appointed July 1, 1985.
[5] Appointed July 1, 1985.
[6] Appointed August 4, 1985.
[7] Appointed August 25, 1985.

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IN MEMORIAM

THE HONORABLE J. GREGORY BRUCE

JUDGE, UNITED STATES TAX COURT

THE HONORABLE J. GREGORY BRUCE

IN MEMORIAM

The Honorable J. Gregory Bruce, retired Judge of the United States Tax Court, died December 3, 1985, at his home in Bethesda, Maryland. He was 88. Judge Bruce is survived by his wife, Zilpha Foster Bruce, their three sons—Dr. William Gregory Bruce of Panama City, Florida, and John Foster Bruce and Charles Moore Bruce, both attorneys in Washington, D.C.—and two grandchildren.

Judge Bruce was appointed to the United States Tax Court in May 1952 by President Harry S. Truman to fill the unexpired term of Judge J. Russell Leech, who died February 5 of that year. He was reappointed by President Dwight D. Eisenhower in May 1958 for a full term of twelve years and continued to serve as a Tax Court Judge until his retirement on May 31, 1967. Judge Bruce was immediately recalled by Judge Norman O. Tietjens, then Chief Judge, and served as a Senior Judge until December 31, 1981.

Judge Bruce was born in Edinburg, Indiana, on February 16, 1897, and attended public schools in Indiana and in Pineville, Kentucky. He was in the United States Naval Reserve from 1918 to 1921. Judge Bruce received his A.B. degree from Transylvania University, Lexington, Kentucky, in 1921, and his LL.B. degree cum laude from the University of Kentucky in 1924. He married Zilpha Foster of Mayfield, Kentucky, in 1930, and had three sons.

Judge Bruce was a member of the Order of the Coif and served for two years as Editor-in-Chief of the Kentucky Law Journal. He was admitted to practice before the Court of Appeals of Kentucky in 1923, and was a member of the Bars of the Supreme Court of the United States, the United States Courts of Appeals for the Fourth, Sixth, Ninth, and Tenth Circuits, and the United States District Courts for the Eastern District of Kentucky and the Eastern District of Michigan.

J. Gregory Bruce was an attorney with Fordson Coal Company, (a subsidiary of Ford Motor Company), in Pineville, Kentucky, and Detroit, Michigan, from 1924 to 1931. He was engaged in private practice from 1931 until 1934 when he joined the Department of Justice in Washington, D.C. He was assigned to the Appeals Division, Bureau of War Risk Litigation, where he worked from 1934 to 1936. He served as Chief, Trial Division, Bureau of War Section, Claims Division (now Civil Division), from 1943 to 1951, and he was Chief, Frauds Section, Claims Division, until his appointment to the Tax Court in 1952.

Judge Bruce was a trustee and elder of the Bethesda Christian Church in Chevy Chase, Maryland, was president of the Kentucky Society of Washington, and was a Mason.

REMARKS BY JUDGE HOWARD A. DAWSON, JR.

Memorial Service
for
JUDGE J. GREGORY BRUCE
Bethesda Christian Church
Chevy Chase, Maryland
December 5, 1985

Yesterday Judge Bruce's son, Charles, called and told me of his father's death on Tuesday evening. He asked me if I would say a few words at this memorial service. I am pleased to do so because I know how difficult it is for a son to lose his father. I have experienced it. The loss is very great.

It is indeed an honor and privilege for me to speak about my dear friend and colleague, J. Gregory Bruce, and for me to share with you the respect and admiration we have for a remarkable man, an able lawyer, a good judge, and a very gentle person who was close to all of our hearts. To the Judges and employees of the United States Tax Court and to his professional and personal friends, Greg Bruce was a man for all of us—his unfailing kindness, courtesy, gentleness, and tact were combined with wisdom, energy, and dedication to shape a career of achievements in advancing the cause of justice in this Nation. While firm in his convictions, Greg Bruce was always

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unpretentious and good humored. There is no doubt that he leaves behind an example of honorable and effective public service, responsive to the events of his time. But probably more than anything else, there was a real down-to-earth human quality about him that was always apparent in everything he did and said. He was, quite simply, a wonderful person. His family knew it; his fellow Judges knew it; his executive secretary, Hazel Riggins, who was with him during his entire Tax Court career knew it; his law clerks knew it; and his friends knew it.

I remember how cordial, friendly, and helpful Judge Bruce was to me when I first came to the Tax Court. He gave me wise advice. I also remember the first time I brought my daughter, Suzy, then only five years old, to the Court to meet some of the judges. She immediately took a liking to Judge Bruce and he to her. From time to time he sent her small gifts—one was her first bottle of perfume. Suzy always wanted to see Judge Bruce when she visited the Court because, as she said, "He's just like my granddaddy." And I remember when I asked Greg if he would object if I employed Charles as my law clerk. He said, "No, but just don't hold me responsible for Charles' actions."

Greg Bruce was a Kentuckian through and through. He often used homespun Kentucky phrases. One, in particular, pertained to statements made in anger. Judge Bruce used to say, "If you don't say it, you won't have to be sorry for it." The flavor of this frank, proud Scotsman, who was a direct descendant of Robert de Bruce, King of Scotland, appeared in this exchange with a Tax Court petitioner:

> Judge Bruce: Who is your attorney?
> Petitioner: The Lord is my attorney.
> Judge Bruce: Well, I hope He is here because we are beginning this trial and from what I have read in the pleadings, I think you are going to need Him.

After working for Henry Ford and practicing law for several years, Greg served 18 years in the United States Department of Justice before President Truman appointed him to the Tax Court in 1952. He served as a regular Judge until 1967 and continued to work as a Senior Judge until 1982. He was a careful and conscientious Judge who agreed with Harry Truman's statement that "one of the difficulties with all our institutions today is that they have emphasized the *reward* instead of the *service*."

It seems to me that there is, in death, a catholicity of call. At one time or another, each of us must respond to the summons. But also in death there is a selectivity of call. It is as though the Father of us all wishes to confront us by the death of a fine person with what goodness really means and what faithfulness really is.

Thus it is today. But death cannot be all bad when it claims a man like Greg Bruce and bears him gently away from strength to strength, from victory to victory, from life to life.

Death is selective. And when death selected Greg Bruce it is also selected for a renewal of commitment from those of us who knew him. For this occasion brings to bright remembrance and to sustaining contemplation the deep satisfaction and fulfillment in the dedication of Greg Bruce's life and talent to the common good. Because of Greg Bruce we shall leave this place of worship more steadfast, more faithful, more understanding, and more aware of what life is really all about.

I cannot close without saying that while Greg Bruce was a dedicated lawyer, judge, and public servant, in his private life he was devoted to his beloved wife whom he called "Zip," proud of the successes and achievements of his remarkable sons, Greg, the surgeon, and John and Charles, the lawyers, and loving and considerate of others. He was truly a dependable friend. To Zip, Greg, John, and Charles he brought a wonderful blend of commonsense, humor, and compassion. To them he was the best man they ever knew. To others who were associated with him in public and private endeavors, he was a true Scotsman, with lofty ideals in his heart and an iron purpose in his soul. We can all be very thankful that he was with us these many years, and we think it is fitting and proper that his memory is preserved here in this church where he served as a trustee and elder. Now we say farewell to this man of God's own heart. May the Lord bless and keep him, now and forever.

As a Final Tribute and expression of admiration and respect, it is directed that this In Memoriam, statement by Judge Howard A. Dawson, Jr., and the Memorial Proceedings honoring Judge Bruce be made a part of the permanent records of the Court and that copies be sent to the members of Judge Bruce's family.

MEMORIAL PROCEEDINGS HONORING

JUDGE J. GREGORY BRUCE

Upon notice of Judge Bruce's death, the Judges of the Tax Court presiding at trial sessions in progress directed proceedings in his honor. The following proceedings were held at Philadelphia, Pennsylvania, Judge Edna G. Parker presiding; Miami, Florida, Judge Meade Whitaker presiding; San Diego, California, Judge Stephen J. Swift presiding; San Francisco, California, Judge Julian I. Jacobs presiding; and Phoenix, Arizona, Judge Joel Gerber presiding:

Philadelphia, Pennsylvania

December 10, 1985

JUDGE EDNA G. PARKER PRESIDING

JUDGE PARKER: It is with deep sorrow that the Court announces the death of Judge John Gregory Bruce, who died on December 3, 1985. Judge Bruce, known affectionately as "Greg" by his fellow Judges, colleagues, and friends, had a long and distinguished career as a lawyer and jurist.

Judge Bruce was born in Indiana in 1897. He served in the United States Naval Reserve, both during and after World War I. He received his A.B. degree, in 1921, from Transylvania College, Lexington, Kentucky. In 1924 he received his LL.B. degree, cum laude, from the University of Kentucky, where he had an outstanding academic career in law school. He served as the Editor-in-Chief of the Kentucky Law Journal, and was a member of the Order of the Coif. He was also a member of the legal fraternity, Phi Alpha Delta.

After being admitted to practice law in Kentucky, he was admitted to the Court of Appeals for the Fourth, Sixth, Ninth, and Tenth Circuits, and the United States Supreme Court. Judge Bruce practiced law in Kentucky, and in Michigan from 1924–1931, as an attorney for a subsidiary of the Ford Motor Company. Thereafter he was in private practice in Kentucky from 1931–1934.

Following his private practice in Kentucky, Judge Bruce had an outstanding career as a lawyer with the U.S. Department of Justice, where he served as: an attorney from 1934–1936 in the Appeals Division, of the Bureau of War Risk Litigation; Chief of the Trial Division, of the Bureau of War Risk Litigation from 1936–1943; Acting Assistant Chief, 1943–1951, of the Frauds Section, Claims Division, which is now known as the Civil Division of the Department of Justice; and Chief of the Frauds Section, Claims Division, until his appointment to the Tax Court in 1952.

In 1960, when as a young trial attorney, I went to the Department of Justice, I found that many of the Justice attorneys still spoke with great affection, and high regard, for their friend "Greg" who had been elevated to the bench.

Judge Bruce was appointed to the Tax Court by President Harry S. Truman in May of 1952. He served on the Court as an active judge until June of 1967. After he assumed senior status in 1967, he continued to serve on recall, and carried practically a full load of cases for another 10 years.

When I came to the Tax Court, as a Special Trial Judge in 1977, Judge Bruce was still carrying a very heavy caseload. He was "the legendary 'Greg' " whom I had heard about for so many years. And I must admit, it was a couple of years, before I had the courage to call him "Greg." But I found him to be a warm, kindly human being, as well as a fine Judge. While Judge Bruce was beginning to slow down a bit physically, his mind was as sharp and as keen as ever. He was particularly helpful to me as a neophyte judge. He was generous with his time, and with his vast legal knowledge that he had acquired through his long experience as a lawyer and as a Judge. Judge Bruce continued to serve on recall as a Senior Judge of the Tax Court until December 31, 1981.

Judge Bruce made me feel very much at home at the Tax Court, and a part of the Tax Court family. I must also say that family and community service were two other important facets of this fine man's life. He and his family attended the Bethesda Christian Church in Bethesda, Maryland, where he was a Trustee and an Elder. He was a member of the Masons and had been a Past Master, and a Past Commander. Judge Bruce served as the President of the Kentucky Society of Washington D.C., and was a member of the District of Columbia, Federal, and American Bar Associations. While he gave of himself to his profession and his community, he was above all a devoted family man. He was married for fifty-five years to his beloved Zilpha, whom he affectionately called "Zip." He and Zip had three fine sons, William Gregory Bruce, of Panama City Florida, and John Foster Bruce, and Charles Moore Bruce, of Washington D.C. Judge Bruce was also blessed with two fine grandchildren.

Judge Bruce spoke with pride of his sons and their many accomplishments. William Gregory Bruce is a doctor, and John Foster Bruce and Charles Moore Bruce are lawyers. When Judge Bruce spoke of his wife, "Zip," which was often, there was always a twinkle in his eye, and a warm glow of love on his face.

Judge Bruce was a good lawyer, a dedicated public servant, and an outstanding Judge. Above all, he was a good human being. He will be missed by all of his colleagues at the Court, by his many friends in the legal profession, and most of all by his devoted family. We were privileged to have known and shared some part of our lives with such a man.

Miami, Florida

December 5, 1985

JUDGE MEADE WHITAKER PRESIDING

JUDGE WHITAKER: Ladies and gentlemen, may we remain standing for just a moment.

I have the sad duty to announce the death of one of our colleagues, Judge J. Gregory Bruce, on December 3, 1985, in Bethesda, Maryland.

Judge Bruce was appointed to the Tax Court in May of 1952 by President Truman, and was reappointed by President Eisenhower. He retired in 1967, but continued to serve on recall. Prior to joining the Court, Judge Bruce had a distinguished career as a lawyer, both in private practice and for the Government.

Although few of us now on the Court served with Judge Bruce during his active days, we all respected his substantial contributions to the continuing development by this corps of the national body of tax law.

After his full retirement, Judge Bruce continued to visit us in Washington, which was a very pleasant reminder of the continuity, admission and purpose, and the collegiality in our relations with each other, which has long characterized the United States Tax Court.

Judge Bruce will be greatly missed.

San Diego, California

December 6, 1985

JUDGE STEPHEN J. SWIFT PRESIDING

JUDGE SWIFT: Before we reconvene with the scheduled trial, I wish to announce the death of the Honorable J. Gregory Bruce. He died from a heart attack on Tuesday at his home in Bethesda, Maryland.

Judge Bruce served on the Tax Court for more than 29 years. He was appointed in 1952, and took senior status in May of 1967. He continued to hear cases until 1981.

As a relatively new Judge on the Tax Court, I never had the privilege of knowing Judge Bruce. However, during the course of my tax law career I benefited from his carefully written and thoughtful opinions, and have continued to do so in deciding cases during the past two years I have been on the Court.

In addition to being widely respected as a Judge of this Court, Judge Bruce was well-known as a devoted family man and as an outstanding citizen.

We extend our sincere sympathies to Judge Bruce's family at this time.

San Francisco, California

December 5, 1985

JUDGE JULIAN I. JACOBS PRESIDING

JUDGE JACOBS: With sadness I must inform those present of the death of Judge J. Gregory Bruce who served this Court with distinction for more than 29 years. Judge Bruce was appointed to the Court in 1952 by President Truman and was reappointed by President Eisenhower. He retired as a Judge of the Court in 1967.

Judge Bruce was born in Edinburg, Indiana, on February 16, 1897. He received his law degree (cum laude) from the University of Kentucky in 1924. He was respected as a jurist by both his colleagues and the entire tax bar. In Judge Bruce's passing, we feel a deep sense of loss. I request a moment of silence in his memory.

Phoenix, Arizona

December 5, 1985

JUDGE JOEL GERBER PRESIDING

JUDGE GERBER: Good morning, ladies and gentlemen. I am deeply saddened to report the passing of Judge J. Gregory Bruce on Tuesday evening, December 3, 1985. It is for that reason that we feel compelled to take time to appear specially on the record at this session of the Court at Phoenix, Arizona.

Judge Bruce was appointed by President Harry S. Truman, in 1952, and was reappointed for a full term by President Dwight D. Eisenhower, in 1958.

He had retired on May 31, 1967, but, until recently, was ably handling cases on a recalled basis. In all, he served on this Court for about 30 years.

Judge Bruce was born in Edinburg, Indiana, on February 16, 1897. He married Zilpha Foster, of Mayfield, Kentucky, in 1930, and they had three sons.

Judge Bruce served on active duty in the United States Naval Reserve during World War I.

He was a distinguished academic and culminated his education with an LL.B. from the University of Kentucky, School of Law, in 1924. Judge Bruce was admitted to practice before many bars, including that of the Supreme Court of the United States. He began his career as an employee of the Fordson Coal Company, a subsidiary of the Ford Motor Company, where he had several positions between 1924 and 1931. He then practiced in the private sector until 1934, when he joined the Justice Department. He held successively responsible positions there until his 1952 appointment to the Court.

His professional and academic memberships include the Order of the Coif, Phi Alpha Delta Legal Fraternity, Phi Kappa Tau, Mason, and the American, District of Columbia, and Federal Bar Associations. Judge Bruce was a trustee and elder of the Bethesda Christian Church.

I appeared on several occasions before Judge Bruce and his judicial presence and demeanor were impressive. He possessed the rare combination of good judgment and commonsense, coupled with an exceptional intellect. He made both counsel and witness feel comfortable by means of his compassionate and warm personality.

Judge Bruce was proud of his agrarian and rural beginnings and he possessed the type of strength of character and personal commitment that has provided the foundation upon which our great democracy was built. He will be dearly missed by this Court, the Tax Bar and, indeed, the entire legal community.

The Court is pleased at this time to recognize Stephen W. Craig, a Phoenix lawyer, who will speak on behalf of the Arizona Bar Association. Mr. Craig.

MR. CRAIG: I am very glad to have the opportunity to appear this morning and to speak on behalf of the Bar of the State of Arizona, but, more particularly, on my own behalf, because over 20 years ago, in fact 24 years, I was a legal assistant at the Tax Court and Judge Bruce took me as his law clerk. It was perhaps the best legal learning experience that I ever had.

There is a line, and I think it is in The Web and the Rock, by Thomas Wolfe, in which the author says about George Webber, one of the characters, "There were certain things that stuck in George Webber's mind like burrs in a Scottie's tail." There are some things that have stuck in my mind about Judge Bruce because he was a memorable human being. When I met Judge Bruce, I was working for the Internal Revenue Service in counsel's office. I had an opportunity to come to the Court and to be interviewed by Judge Bruce for a clerkship with him. We sat in his office and after about 15 minutes, he turned to me and said, "All right. Well, then, you can go to work." And I had thought it was going to be a long process. I was taken aback because, although I wanted the job very much, I had not anticipated that it would happen so quickly. It was not unlike Judge Bruce to be able to absorb the information that he thought he needed and make a decision on it, with some degree of alacrity and, yet, with good care. I hope that in my case that he felt it was with good care.

He was thereafter, I think, more a teacher and more of a gentle teacher than he was a boss. I found that the time that I spent with him at the Court was a time when I was able to be more reflective than perhaps I have been in the practice of law ever since. I found that it was a time when I could pose the ideas I had about a case and discuss them with him without ever being made to feel that I was silly or foolish, although I am sure that on many occasions I was both.

We had a case, in which the Government correctly pointed out in a decision that we were working on, that a deficiency had been misstated. Judge Bruce, who had relied upon me in this particular instance, had a hearing, and after the Government pointed it out and he accepted the fact that the amount should be corrected, he turned to the Government lawyer and said, "I want you to know, however, and I want you to carry this message back to Chief Counsel's Office, that I think if we hadn't made this mistake, I am not sure that this fellow would have got back the amount of refund he's supposed to get, and I want you to make sure that it happens."

In later months, when I found out that I had to leave the Court because of an illness in the family and move to Phoenix, which would be a better environment for the illness, Judge Bruce called me in and, in a rather careful way, thanked me for the work I had done with him and thanked me for staying as long as I had. He said that while he was certain that I would do all right in the future, he really felt that I could use a little more time and a little more training with him. I appreciated the words.

Judge Bruce represented, I think, a part of what is the very best in the legal profession and in many people who are in Government service. He was not a man with a great ego, although he was someone with great concern for doing what was right and what should be done, and he did not lack pride. He was someone whose decisions were thoughtful, careful, well-crafted, and who believed that what he was doing was worth doing. He believed that the process of an ordered society was one that was a meaningful altar to which he could bring his best talents. He brought them, and he gave me a great deal of personal assistance in my life and in my training and gave much to his country and to our society.

I will miss him and I will cherish always the memory of a very fine man and a very good judge. Thank you for giving me the opportunity to be here.

JUDGE GERBER: Thank you, Mr. Craig.

The Court is now pleased to recognize Roger Rhodes, who is the District Counsel in Phoenix for the Internal Revenue Service. Mr. Rhodes.

MR. RHODES: May it please the Court, on behalf of the Chief Counsel, the Regional Counsel for the Southwest Region, and my colleagues in the Phoenix Office, I would like to express my very deep regret to learn of the passing of Judge Bruce.

Although I appeared before Judge Bruce on a number of occasions, the one occasion I recall in particular was my first appearance, because that was also my first trial before the United States Tax Court. In all candor, I could not have had a better introduction to practice before this Court. Judge Bruce presided during that trial with great dignity, he had a great sense of the orderly presentation of a trial, he was extremely patient and, yet, very firm. It, overall, was a very good experience.

We will all miss Judge Bruce, and I appreciate the opportunity to appear today. Thank you.

JUDGE GERBER: Thank you, Mr. Rhodes.

That concludes our special session at Phoenix. We stand adjourned until 10 o'clock.

TABLE OF CASES REPORTED

	Page
Adams, Dayton, Jr., and Shelly A.	359
Adler, Charles and Edwina	535
Anesthesia Service Medical Group, Inc	1031
Anesthesia Service Medical Group, Inc, Employee Protective Trust	1031
Atlantic Veneer Corp	1075
Bagley, Hughes A. and Marilyn B	663
Ballard, Claire M., Estate	300
Barbados #5 Ltd., a Partnership, Bajan Services, Inc., Tax Matters Partner	900
Barbados #6 Ltd., a Partnership, Bajan Services, Inc., Tax Matters Partner	900
Barone, Edward	462
Baumgardner, Richard B., Estate	445
Beck, Stanley and Helen	557
Becker, William L. (supplemental)	291
Bell, Edwin Richard and Doris Valerie	436
Bittner, Louis W. and Sandra M	332
Boyd, Edward A., Estate	1056
Bramblett, Richard H. and Patsy J	127
Brown, Dennis S., et al	968
Brown, Dennis S., et al. (opinion withdrawn)	397
Buchbinder, Richard J. and Voren L	580
Budget Films, Inc	114
Calder, Louisa J	713
Ciba-Geigy Corp	172
Clifford, Donald R. and Joyce K	580
Coleman, Ronald and Nancy (opinion withdrawn)	622
Colonial Savings Association and Subsidiaries	855
Crow, Tedd N	376
Cuttone, Frank J. and Marsha L	332
Dahlstrom, Karl L. and Clara J	812
DeVenney, John J., Jr., and Shirley D	927
Eanes, Thomas S. and Barbara	168
Easterling, Lawrence H., Jr., and Phyllis R	127
Edelman, Samuel and Sylvia	1064
Enrici, David C. and Marianne	127
Ewart, Roger L., Fiduciary and Transferee of the Assets of the Estate of Blanche L. Ewart	544
Falsetti, Michael S. and Marilyn H., et al	332
Farmers Cooperative Co. (Successor-in-name to Farmers Co-Op Oil Co.)	601
Farmers Cooperative Society	601
Formsma, Gerald R. and Constance Y	127
Forseth, Arnold T., et al	127
Fuentes, Ramon and Audra V	657

	Page
Gelbart, June Baumgardner (formerly June E. Baumgardner), personal representative	445
Gordon, Everett J. and Marian K	309
Greene, Martin I. and June A	1024
Griswold, Kenneth P. and Florine	869
Herrick, Donald L. and Marjorie P	237
Hilborn, Michael G. and Helene	677
Hongkong & Shanghai Banking Corp	701
Indich, Alex and Mira	580
J. A. Tobin Construction Co	1005
Johnson, Frederick C. and Judith A	469
Johnson, Jane K., et al., Coexecutrices	25
Kandel, Peter F. and Barbara M	485
Kincaid, Nelle W., Estate	25
Knox, Arthur	580
Leamy, Frank A. and Charlotte T	798
Leinbach, James N. and Mary Alice	968
Lessinger, Sol and Edith	824
Lio, Peter J. and Catherine A	56
Mahoney, Stephen A., III, and Mary Ann	127
Marshall, Spurgeon and Estate of Thelma	267
McIntosh, John	31
McKenzie, Jerrold L. and Sally A	875
Medefind, J. Neil and Helen	332
Miller, Robert J. and Susan F	1064
Moden, John B. and Ruth	731
Molsen, Elizabeth	485
Molsen, Frederick G. and Jayne F	485
Molsen, Heinz, Jr., and Christina T., et al	485
Monterey Pines Investors	332
Moore, Joseph F	72
Morgan, Ellison C. and Linda	968
Naftel, Donald A	527
Neely, Ralph and Virginia G	934
Nelson, Willie H. and Connie (Constance)	914
Orth, David H. and Barbara A	56
Paccar, Inc., and Subsidiaries	754
Packard, Sue B., a.k.a. Virginia S. Wainwright	397
Paley, Harold W	1064
Paley, Phillip and Dorene	1064
Pleasanton Gravel Co., Successor in Interest to Rio Gravel, Inc	839
Pritchett, Jerry E. and Patricia D., et al	580
Reinhardt, Jules and Marilyn D	511
Rust, Myrtle E	284
San Diego Trust & Savings Bank, Trustee	1031
Shriver, Thomas H	1
Sochin, James E	968
Solowiejczyk, Henry and Anita	552

Page

St. Joseph Farms of Indiana Brothers of the Congregation of Holy Cross, Southwest Province, Inc 9
Tobin, J. A., Construction Co 1005
Triune of Life Church, Inc 45
Vanicek, Edward, Deceased, and Sara 731
Virginia Education Fund 743
Wainwright, Richard A 397
Webster, Shirley A., Executor 300
Willie Nelson Music Co 914
Woods Investment Co 274
Wooldridge, Raymond and Ida 127

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REPORTS

OF THE

UNITED STATES TAX COURT

THOMAS H. SHRIVER, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2235-83. Filed July 1, 1985.

During 1977 and 1978, petitioner sold methamphetamine, a controlled substance. In his statutory notice of deficiency, respondent determined that petitioner had unreported income for 1977 and 1978 totaling $4,028,036 attributable to such sales. Respondent's calculation of the amount of unreported income was based upon information supplied by a Government informant to the Drug Enforcement Administration. *Held*, since there is substantive evidence linking petitioner to a tax-generating activity, we will not look behind the statutory notice and decide whether respondent's determination was arbitrary and erroneous. *Held, further*, certain Drug Enforcement Administration reports are inadmissible into evidence because they are hearsay declarations and are not admissible under any of the hearsay exceptions. *Held, further*, the evidence established that petitioner earned $254,240 from the sale of methamphetamine during the years in issue.

Michael E. Marr, for the petitioner.
John F. Dean, for the respondent.

STERRETT, *Chief Judge*: By notice of deficiency dated November 8, 1982, and by amended answer, respondent determined a deficiency in Federal income taxes for the years ended December 31, 1977, and December 31, 1978, and additions to tax under sections 6653(b) and 6654, I.R.C. 1954, as follows:

		Addition to tax under	
Year	*Deficiency*	*Sec. 6653(b)*	*Sec. 6654*
1977	$1,394,781.10	$697,390.55	$49,877.37
1978	1,394,911.30	697,455.65	44,637.16

After concessions[1] the issues before us are: (1) Whether the notice of deficiency was arbitrarily issued, and (2) whether respondent's determination of petitioner's tax liability was incorrect.

FINDINGS OF FACT

Petitioner Thomas H. Shriver resided in Des Plaines, Illinois, at the time of filing his petition in this case. He did not file Federal income tax returns for the taxable years ended December 31, 1977, and December 31, 1978.

During 1977 and 1978, while in graduate school, petitione earned income from the sale of methamphetamine, a controlled substance.[2] The methamphetamine was sold in 10 gram packets for $700, and petitioner sold a total of 8 pound of the drug to four individuals, one of whom was a Governmen informant. During all but 4½ months of 1977 and 1978 Michael Ramano was petitioner's partner in this profitabl business venture.[3]

In his statutory notice of deficiency, respondent determine that petitioner had unreported income for 1977 and 197 totaling $4,028,036 from the sale of methamphetamine. Re spondent's calculation of the amount of unreported incom was based upon information supplied by a Government infor mant[4] to the Drug Enforcement Administration (hereinafte referred to as DEA).

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[1] On brief and at trial, petitioner conceded the addition to tax under sec. 6653(b). Petitione however, failed to address the issue of the addition to tax pursuant to sec. 6654 either at trial or brief, and thus, we assume that he also conceded that issue. Even if petitioner did not concede t sec. 6654 issue, we find that he did not carry his burden of proof on that question.

[2] Petitioner's activity did not go unnoticed by the authorities. He was indicted and pled guilty the charge of conspiring to distribute methamphetamine.

[3] From May 1977 to September 1977, Michael Ramano served time in prison at Eglin Air For Base in Florida for his conviction of the crime of conspiring to distribute heroin.

[4] The informant, who was a distributor of drugs, arranged and made purchases of methamph amine from petitioner while under the surveillance of agents of the DEA.

OPINION

Petitioner maintains that respondent's determination was arbitrary and erroneous in that it was based upon inadmissible hearsay declarations of a Government informant, who was not called to testify at trial. Thus, petitioner argues that respondent had the burden of going forward with the evidence to show the correct amount of his income.

Ordinarily, a presumption of correctness attaches to a statutory notice of deficiency, which places upon petitioner the burden of proof and the burden of going forward with the evidence to show the correct amount of his income. *Welch v. Helvering*, 290 U.S. 111 (1933). If, however, petitioner demonstrates that the statutory notice is arbitrarily excessive or without foundation, then the burden of going forward with the evidence shifts to respondent. *Helvering v. Taylor*, 293 U.S. 507 (1935); *Llorente v. Commissioner*, 74 T.C. 260, 264 (1980), affd. in part and revd. and remanded in part 649 F.2d 152 (2d Cir. 1981).

In requesting this Court to find a statutory notice arbitrary, petitioner is asking the Court to go behind the statutory notice. As a general rule, this Court will not look behind a statutory notice to examine the evidence used by respondent in making his determination. *Dellacroce v. Commissioner*, 83 T.C. 269, 280 (1984); *Riland v. Commissioner*, 79 T.C. 185, 201 (1982); *Llorente v. Commissioner, supra* at 264; *Jackson v. Commissioner*, 73 T.C. 394, 400 (1979); *Greenberg's Express, Inc. v. Commissioner*, 62 T.C. 324, 327 (1974); *Suarez v. Commissioner*, 58 T.C. 792, 813 (1972). In this context, we have observed that "the Commissioner's determination may often rest upon hearsay or other inadmissible evidence, and we know of no rule of law calling for a review of the materials that were before the Commissioner in order to ascertain whether he relied upon improper evidence." *Rosano v. Commissioner*, 46 T.C. 681, 687 (1966).

On rare occasions, however, this Court has recognized an exception to the above-mentioned rule and has looked behind the notice of deficiency. Those cases involved unreported illegal income where respondent introduced no direct or substantive evidence, but rested on the presumption of correctness, and the taxpayer challenged the notice of deficiency. *Dellacroce v. Commissioner, supra*; *Jackson v. Commissioner*, *supra*. We hold that the instant case does not fall within this narrow exception, since there is substantive evidence linking petitioner to a tax-generating activity during the years in issue. Petitioner testified and stipulated to the fact that he earned income from the sale of drugs during 1977 and 1978. He was also convicted of the crime of dealing in drugs during this period. In addition, one of the individuals to whom petitioner sold drugs testified at trial that he purchased 2 pounds of methamphetamine from petitioner in 1977. Respondent clearly did not rest merely on the presumption of correctness in issuing his notice of deficiency. Consequently, we will not look behind the statutory notice in the instant case, and petitioner bears the burden of proving respondent's determination incorrect.

Having found that the notice of deficiency was not arbitrarily issued, we must decide whether respondent's determination was incorrect. Neither party disputes the fact that petitioner owes taxes on unreported income earned in 1977 and 1978. They do disagree, however, with respect to the amount of income earned over the periods in question and the resultant tax liability.

Respondent determined that petitioner earned in excess of $4 million from the sale of methamphetamine during 1977 and 1978. His determination was based upon a DEA report that was written up by an agent of the DEA in his official capacity. The report reflected statements made by a Government informant to the agent, and included a statement, allegedly made by petitioner to the informant, that petitioner only had 1 pound left of the 75 pounds of methamphetamine he had made. Based upon this report, and in particular petitioner's alleged statement to the informant, respondent determined that petitioner had sold 75 pounds of the controlled substance during the years in issue, generating more than $4 million in income.

At trial, petitioner timely objected to the admission of this particular DEA report, as well as related DEA reports, on the grounds that they were hearsay[5] and not admissible under any of the hearsay exceptions. Respondent claims that these documents are admissible in evidence under rules 803(6) and 803(8), Federal Rules of Evidence. Alternatively, respondent maintains that petitioner's statement, that only 1 pound remained of the 75 pounds of methamphetamine he had made, is admissible in evidence as an admission because it is a nonhearsay statement.

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[5] Rule 801(c), Federal Rules of Evidence, defines hearsay as "a statement, other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted." Generally, hearsay is inadmissible as evidence. Fed. R. Evid. 802 provides that—

"Hearsay is not admissible except as provided by these rules or by other rules prescribed by the Supreme Court pursuant to statutory authority or by Act of Congress."

We begin by addressing respondent's contention that the DEA reports are admissible in evidence under Fed. R. Evid. 803(6). This provision allows a business record to be admitted as evidence of the truth of the matters stated if it was made and kept in the regular course of a regularly conducted business activity.[6] As a general rule, the document must either have been made by a person who had firsthand knowledge of the facts recorded, or have been made on the basis of information supplied by an individual who had firsthand knowledge, whose business it was to make such a report. The requirement that the information recorded be based upon firsthand observations of an individual acting in his regular course of business is necessary to ensure that the business records are trustworthy. *United States v. Lieberman*, 637 F.2d 95, 100 (2d Cir. 1980); *United States v. Smith*, 521 F.2d 957, 964 (D.C. Cir. 1975); *United States v. Burruss*, 418 F.2d 677, 678–679 (4th Cir. 1969).

The DEA reports fail to satisfy the business records exception to hearsay statements. The document would not be admissible since we find that it lacks trustworthiness. The informant was a distributor of drugs and we question the circumstances and motives that led to his assisting the Government in its surveillance of petitioner's activities. We also note that, although the informant was present at petitioner's trial, respondent refused to call him to testify. His failure to do so was based, not on the desire to protect the informant's identity, as that was disclosed at trial, but rather on the fact that, according to respondent, the informant could not recollect any of the events that had transpired and would have testified to that effect.

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[6] Fed. R. Evid. 803(6) provides the following exception to the hearsay rule:

"Records of regularly conducted activity. A memorandum, report, record, or data compilation, in any form, of acts, events, conditions, opinions, or diagnoses, made at or near the time by, or from information transmitted by, a person with knowledge, if kept in the course of a regularly conducted business activity, and if it was the regular practice of that business activity to make the memorandum, report, record, or data compilation, all as shown by the testimony of the custodian or other qualified witness, unless the source of information or the method or circumstances of preparation indicate lack of trustworthiness. The term "business" as used in this paragraph includes business, institution, association, profession, occupation, and calling of every kind, whether or not conducted for profit."

Respondent also argues that the documents should be admitted in evidence under Fed. R. Evid. 803(8). We again disagree. That provision is another exception to the hearsay rule and permits the admission of public records and reports in evidence if certain criteria are met, unless the sources of information or other circumstances indicate lack of trustworthiness.[7] We find that this exception does not apply since we have determined that the sources of information, the informant's statements, are not trustworthy. Respondent maintains that, with respect to the issue of trustworthiness, petitioner bears the burden of proof, which he has failed to carry. We agree that petitioner has the burden of showing that a public record or report is inadmissible because its sources of information or other circumstances indicate a lack of trustworthiness. *Kehm v. Procter & Gamble Mfg. Co.*, 724 F.2d 613, 618 (8th Cir. 1983); *Baker v. Elcona Homes Corp.*, 588 F.2d 551, 558 (6th Cir. 1978), cert. denied 441 U.S. 933 (1979); *Zenith Radio Corp. v. Matsushita Elec. Ind. Co.*, 505 F. Supp. 1125, 1148 (E.D. Pa. 1980). However, we have found that the evidence established that the informant's statements were not trustworthy. Even though the evidence came into the record through respondent's witnesses, we see no reason why respondent should not be allowed to prove petitioner's case with respect to this issue if he so chooses.

Lastly, respondent argues that the statements made by petitioner to the informant, which were recorded on the DEA report, are admissions which are nonhearsay and thus admissible in evidence. The DEA report reflects what the informant told the agent with respect to petitioner's alleged statements, so in essence, we are dealing with an admission within hearsay.

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[7] Fed. R. Evid. 803(8) provides the following exception to the hearsay rule:

"Public records and reports. Records, reports, statements, or data compilations, in any form, of public offices or agencies, setting forth (A) the activities of the office or agency, or (B) matters observed pursuant to duty imposed by law as to which matters there was a duty to report, excluding, however, in criminal cases matters observed by police officers and other law enforcement personnel, or (C) in civil actions and proceedings and against the government in criminal cases, factual findings resulting from an investigation made pursuant to authority granted by law, unless the sources of information or other circumstances indicate lack of trustworthiness."

Pursuant to Fed. R. Evid. 801(d)(2)[8] an admission is nonhearsay, rather than an exception to the hearsay rule. Consequently, hearsay within an admission does not fall strictly within Fed. R. Evid. 805, which governs "hearsay included within hearsay."[9] Even so, the law has stated that the requirements of Fed. R. Evid. 805 must be satisfied in order for hearsay within an admission to be admissible in evidence. *United States v. Lang*, 589 F.2d 92, 98–99 (2d Cir. 1978); *Zenith Radio Corp. v. Matsushita Elec. Ind. Co.*, 505 F. Supp. 1190, 1266 (E.D. Pa. 1980). See also C. McCormick, Evidence, sec. 324.3, at 912 (3d ed. 1984). Since the DEA reports are not admissible in evidence for the reasons previously stated, it follows that Fed. R. Evid. 805 cannot be satisfied in the instant case, and thus, petitioner's statements allegedly made to the informant also are not admissible in evidence.[10]

With respect to the question of how much income petitioner earned during 1977 and 1978, petitioner argues that he had income in the amount of $40,000, which was generated from the sale of methamphetamine. He testified at trial that he sold 8 pounds of the controlled substance at a price of $700 per 10-gram packet, and that he had purchased the drug for $1,500 an ounce. His testimony concerning the quality of methamphetamine sold and the price at which he sold it was supported by other evidence in the record. One of respondent's witnesses testified that he bought 2 pounds of the drug from petitioner during the periods in issue. Since petitioner had sold the controlled substance to four individuals, we find that the evidence supports his contention that he sold 8 pounds.

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[8] Fed. R. Evid. 801(d) provides that a statement is not hearsay if—

"(2) Admission by party-opponent. The statement is offered against a party and is (A) his own statement, in either his individual or a representative capacity or (B) a statement of which he has manifested his adoption or belief in its truth, or (C) a statement by a person authorized by him to make a statement concerning the subject,or (D) a statement by his agent or servant concerning a matter within the scope of his agency or employment, made during the existence of the relationship, or (E) a statement by a co-conspirator of a party during the course and in furtherance of the conspiracy."

[9] Fed. R. Evid. 805 provides that—

"Hearsay included within hearsay is not excluded under the hearsay rule if *each part* of the combined statements conforms with an exception to the hearsay rule * * *." [Emphasis added.]

[10] Even if the DEA reports were admissible as evidence, when weighed against the other evidence in the record, our decision would remain unchanged.

Further, other evidence properly admitted into the record corroborated petitioner's testimony that he sold methamphetamine for $700 per 10-gram packet. We also note that while petitioner and Michael Ramano were partners in this profitable business venture, petitioner failed to present any credible evidence with respect to their respective shares of income from the sale of the controlled substance. Since Michael Ramano was in prison for 4½ months during which he did not participate in the business venture, and since we cannot decipher from the record how much methamphetamine was sold during that period, we are not in a position to determine his share of the income generated from the drug sales. Having failed to satisfy his burden of proof on this issue, we attribute all income generated from such sales to petitioner.

Petitioner's testimony with respect to his contention that he had purchased his supply of methamphetamine for $1,500 an ounce is not supported by the record. He testified that a person named "Paul" had supplied him with the controlled substance. Even though petitioner allegedly had dealt with this individual during 1977 and 1978, he could not remember anything with respect to the supplier, such as his last name or address. Furthermore, his partner Michael Ramano testified that the supplier's name was Tom, not Paul. Based upon the incomplete and inconsistent testimony, we find that petitioner manufactured the methamphetamine he sold, and did not purchase any of it from a supplier. No deduction for cost of goods sold is permitted because petitioner failed to establish the cost incurred in manufacturing the drug. Accordingly, we hold that petitioner had income in the amount of $254,240[11] from the sale of methamphetamine during 1977 and 1978.

Decision will be entered under Rule 155.

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[11] This amount was calculated as follows. There are approximately 454 grams in a pound, and petitioner sold 10 grams of methamphetamine for $700, or for $70 per gram.

$70 × 454 = $31,780 for a pound of methamphetamine.

Since petitioner sold 8 pounds of methamphetamine, the income he generated from such sales totaled $254,240 (8 × $31,780).

ST. JOSEPH FARMS OF INDIANA BROTHERS OF THE CONGREGATION OF HOLY CROSS, SOUTHWEST PROVINCE, INC., PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 27830–81. Filed July 1, 1985.

Petitioner, an Indiana not-for-profit corporation, is exempt from tax as a member of the U.S. Catholic Conference, which has been granted a group exemption under sec. 501(c)(3), I.R.C. 1954. Petitioner is part of the Congregation of the Holy Cross, an apostolic religious order. Prior to 1955, the Holy Cross Brothers had but one province in the United States. In 1955, that province was divided into three separate provinces (Southwest, Midwest, and Eastern), and petitioner was given to the Southwest Province to provide that province with a source of income.

Petitioner operates a 1600 acre farm in St. Joseph County, Indiana, on which it produces cattle and crops that it markets commercially. Ninety-one percent of the farm labor force and ninety-four percent of the total hours worked on the farm are provided by the Holy Cross Brothers. All of the Brothers are under a vow of poverty and the Brothers who operate the farm only receive support from the order. *Held*, petitioner's farming activity is a trade or business that is not substantially related to its exempt purposes; however, because substantially all of the farm work is performed without compensation, the activity falls within the exception to the definition of a trade or business set forth in section 513(a)(1).

David T. Link, for the petitioner.
Elsie Hall, for the respondent.

JACOBS, *Judge*: Respondent determined the following deficiencies in petitioner's income tax:

TYE June 30—	*Deficiency*
1977	$857
1978	7,522
1979	18,836

The issues for decision are: (1) Whether the farming operations conducted by petitioner (an organization exempt from income tax pursuant to section 501[1]) during the years 1977, 1978, and 1979 constitute the conduct of an unrelated trade or business within the meaning of section 513, and (2) if the farming operations constitute an unrelated trade or business, whether substantially all of the work in carrying on the trade or business was performed without compensation.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years at issue.

FINDINGS OF FACT

This case has been submitted for decision under Rule 122, Tax Court Rules of Practice and Procedure. The stipulation of facts and accompanying exhibits are so found and are incorporated herein by this reference.

Petitioner St. Joseph Farms of Indiana Brothers of the Congregation of the Holy Cross, Southwest Province, Inc., was incorporated under the Indiana General Not-For-Profit Corporation Act, Ind. Code Ann. sec. 23–7–1.1–1 et seq. (Burns 1972), on July 22, 1965. Petitioner is exempt from taxation as a member of the U.S. Catholic Conference, which has been granted a group exemption under section 501(c)(3) as a religious organization. Where an organization is granted a group exemption, the articles of incorporation of each subordinate organization are not separately examined.

The Congregation of the Holy Cross was founded in France during the troubled period following the French Revolution, and was permanently established in the United States in 1841.[2] Until 1955, the Holy Cross Brothers had only one province in this country. In 1955, the U.S. province was divided into three separate provinces: (1) The Southwest Province, (2) the Midwest Province, and (3) the Eastern Province. Although geographically petitioner falls within the Midwest Province, it was given to the Southwest Province in order to provide that province with a source of income.

The original purchase of the land for petitioner was made in 1867. Since that date, the Holy Cross Brothers have operated St. Joseph Farms. Within the last 15 to 20 years, St. Joseph Farms was expanded through the acquisition of a section of land known as St. Bernard's Farm.

In 1956, the appraised value of St. Joseph Farms was approximately $721,000. As is true for many other commercial farming operations that have been in existence for an extended period of time, the farm has appreciated substantially in value over the years.

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[2] In 1842, Rev. Edward F. Sorin and six Brothers of the Holy Cross opened a boarding school near South Bend, Indiana. This school was to become the University of Notre Dame.

At present, petitioner's farm operation consists of approximately 1600 acres of land. Of this total acreage, approximately 1300 acres are planted in corn, wheat, and soybeans. Additionally, there is a feedlot for approximately 500 beef cattle.

Besides several outbuildings which are used as storage sheds for equipment, a machine shop, and shelter for the cattle, the physical plant includes corn-drying facilities and several large storage silos.

There are two houses on the property. One house contains a chapel, offices, living quarters, kitchen, dining area, and a recreation room for the Brothers, and the other house contains an office, library, and recreation room, and additional living quarters.

Petitioner owns all of its own farm equipment. Petitioner's equipment includes three large, four-wheel drive, enclosed-cab tractors; four smaller tractors; a combine; a semi-tractor with three different trailers; a crane used for digging ditches; and an assortment of plowing, seeding, and fertilizing equipment. In addition, petitioner owns several cars and smaller trucks.

Some of the corn raised by petitioner is used for cattle feed. The remaining corn and soybeans, wheat, and cattle are marketed from a study of market trends, which are followed on a daily basis with quotes from the Chicago Board of Trade and the Mercantile Exchange by way of radio broadcast and the Wall Street Journal. Other factors that are figured into the marketing of petitioner's products are how soon a commodity needs to be moved, and transportation costs to the market. In addition, the farm manager maintains close contact with area farmers and agricultural experts in the marketing of grain and livestock. Long-range forecasts are reviewed through farm magazines.

In taxable years ended June 30, 1978, and June 30, 1979, petitioner participated in certain farm price support programs administered by the Agricultural Stabilization and Conservation Service of the U.S. Department of Agriculture. These programs provide certain benefits (i.e., land diversion payments, commodity loans, target price protection, and certain authorized disaster payments) to farmers who plant one or more program crops (wheat, corn, grain sorghum, barley, or oats) and participate in and comply with the acreage reduction and land diversion program. Petitioner's participation in these programs resulted in its receipt of subsidies of $10,605 for fiscal year 1978 and $11,253 for fiscal year 1979. Petitioner's stated reason for participating in the programs is as follows:

> The Internal Revenue Service has asked for an explanation of St. Joseph Farms' participation in government sponsored farm programs such as the Payment-In-Kind (PIK) presumably because such participation would appear to be motivated by maximizing the profits for the farms. These government programs are set up as an essential part of supporting farm prices across the nation thus insuring the survival of a substantial number of marginal farming operations. If St. Joseph Farms did not participate they would be acting in defiance of this governmental purpose. They could not maintain any credibility among neighboring families or the regional farming community if they refused to participate in these programs. As the director of St. Joseph Farms stated, "There is no way I would have planted fence row to fence row in 1983. There is a human dimension here. I would not want to be guilty of driving young kids away from the farms."

Membership and directorship in petitioner are limited to the Brothers of the Holy Cross that are assigned to the farm by the Provincial Superior of the Southwest Province. A Brother's assignment to any type of work or to a particular location is determined by the Provincial Superior and may be changed at any time. The authority of the director of the farm or of any other provincial endeavor is subject to that of the Provincial Superior. Budgets for all of the works of the province, including the farm, must be approved by the Provincial Superior and his council. In addition, the Provincial Superior and his council must approve certain policies. The director of the farm can make day-to-day decisions with respect to the operation of the farm without reference to the Provincial Superior, provided that those decisions do not impinge upon the budgetary and financial control reserved to the Provincial Superior and his council. Any profit realized by petitioner in a given year is forwarded to the Southwest Province the following year unless the funds are needed to make acquisitions of equipment which have been duly authorized.

The Brothers of the Holy Cross take a vow of poverty which is described in the Statutes of the Proceedings of the General Chapter of 1975 of the Congregation of Holy Cross as follows:

In making his vow of poverty, the religious acknowledges that all income accruing from his work, even supererogatory work, gifts occasioned by his services or by his priestly or religious character, and gifts meant to provide for his personal needs, belong to the congregation (can. 580,2; 594,2).

As for property which comes to the religious after his first commitment, he must cede the administration of it in conformity with statute 17 (can. 569,2). Inheritances, legacies and gifts which are intended by their very nature or by the donor to constitute or increase the patrimony of the religious are presumed to be personal; the authorization of the local superior or director is required to accept or renounce such an inheritance or legacy. As for gifts, this permission is required only for their acceptance.

No superior may permit a religious to use his personal property for himself since it is exclusively from the common funds that provision is to be made for the needs of all (can. 594,1).

Before his perpetual profession, a religious must make a will that meets the requirements of civil law and covers all the property he already owns or may later acquire (can. 569,3). Before first commitment, he must cede for the entire period of his commitment the administration of his property to whom he wishes, determine how it is to be used, and dispose of its income in favor of some charitable work or in favor of anyone he wishes except himself, unless he wishes to add it to his patrimony (can. 569,1). These acts of cession and disposition must be made in instruments having binding force before the civil law, with the stipulation that they are revocable.

Any change in these arrangements or in his will requires the permission of the superior general, or of the provincial if he has been so delegated (CA 17). To dispose of his property in view of some consideration, or to change his will in an urgent case when it is not possible to have recourse to a higher superior (can. 583,2), as well as for all acts required by civil law, the permission of the local superior or director of the residence suffices.

At the time of his admission to the novitiate, the candidate must sign a legal document stating that he renounces all right to receive compensation for himself or his family for the time passed in the congregation, for services rendered or for any other benefit which the congregation may have been able to gain from him.

After advising the provincial, a religious who is perpetually professed may renounce all or part of his patrimony (PC 13; NPC 24). This must be done in conformity with civil law. If the renunciation is made in favor of the congregation, the contract of renunciation must include provisions by which the property will be restored, on presentation of a written request, in case he should leave the congregation for any reason whatever.

No salaries are actually paid to the Brothers, despite the terminology used in petitioner's financial reports and returns. Household expenses and each Brother's personal expenses are totaled, and then this figure is allocated to either the farm or cattle operation under the heading of "salary" on petitioner's financial reports and returns. The allocation is based on the total time each Brother spends with either operation. In addition, petitioner is assessed $1,650 each year for each brother by the Southwest Province. The assessment is reported as "Charge for Member Serv."

The Brothers who reside on the farm receive food, clothing, shelter, and medical care, regardless of whether they are involved in farm operations or other work of the religious community. The South-West Province has elected under the FICA regulations[3] to make FICA payments for the Brothers at the farm based upon average living expenses. Petitioner's explanation for the Brothers' participation in FICA is as follows:

> The Brothers of Holy Cross participate in Social Security because such participation was made available to them by a special provision allowing coverage of members of a religious order who are under a vow of poverty. The history of F.I.C.A. Sec. 3121(r) makes it clear that Congress was allowing coverage of those who do not get personal compensation for their labor. In fact, the Regulations Sec. 31.3121(i)-4 set up a fictional "wage" and compute the contribution for all Brothers at the same amount no matter what the work of each Brother (including Brothers who are going to school instead of working).

The Brothers' daily schedule at the farm is as follows:

5:00 a.m.	Rising
5:30 a.m.	Morning prayer followed by common meditation
6:00 a.m.	Liturgy—celebration of Mass
6:45 a.m.	Breakfast
7:30 a.m.	Work begins
11:30 a.m.	Work ends/prepare for dinner/visit to chapel
12:00 p.m.	Dinner
12:45 p.m.	Work résumés
5:00 p.m.	Work ends/prepare for supper/visit to chapel
6:00 p.m.	Supper
6:30 p.m.	Evening prayer and private devotions

At various times during the year, this schedule is modified to accommodate seasonal changes and the observance of religious holidays.

Between 12 and 14 of the Brothers engaged in the operation of the farm. These brothers provide approximately 91 percent of the full-time labor and perform approximately 94 percent of the total hours worked. The balance of the labor required to run the farm is provided by part-time outside help.

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[3] Sec. 3121(r); 26 C.F.R. sec. 31.3121(r)-1 (1984).

A priest, who is a member of the priests' society of the Holy Cross, lives with the Brothers on the farm and serves as chaplain. The chaplain performs sacerdotal functions such as celebrating Mass and administering the sacraments. He receives a check for $900 for each 6-month period. The actual charge is $1,450 every 6 months, but $550 is deducted for room and board.

Apart from the farming activity, the Brothers often provide counseling on individual spiritual problems, matters of personal faith, and troubled family situations. They do not maintain office hours but are generally available to those seeking counseling. In response to a questionnaire[4] circulated among the neighboring community and inquiring as to the benefits to the community that have resulted from the presence of St. Joseph Farms and the Holy Cross Brothers, the following responses were received:

> A. From my own personal experience, when I was younger one of the Brothers taught me religious classes. I then received my sacraments, Holy Communion and Confession.
>
> B. They have the respect of anyone and everyone that knows the operation. Truly a guiding light to a true Christian way of life. Anyone knowing their operation and ways has had his life enriched.
>
> C. Through my visits and contacts with the Brothers my wife (a convert) and I have had our religion reinforced by the fellowship and examples of charity and love put forth by the Brothers.
>
> D. Personally we are Hindus by religion. We learn more about Christianity and Christians whenever we visit the Brothers at St. Joseph Farms; the more we associate with them, the more we like and respect Christianity and Christians.
>
> E. Religiously I, and also my family, by joining the Brothers at prayer both at mealtimes and chapel, have come to understand more the community of man and also to learn first-hand about the Brothers of Holy Cross.
>
> F. When our family has had major medical problems the Brothers at St. Joseph's Farm have always helped us with their words and prayers. We have joined them in Mass and prayer in their chapel and are always welcome. They have given us gifts of handsome rosaries which our whole family use.
>
> G. It has always been spiritually uplifting to witness the Brothers and the Holy Cross Community at work among the people of St. Joseph County. The fact that the Brothers are working primarily out of a religious motivation

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[4] The questionnaire responses were included in Joint Exhibit 26-Z, which consists of the "Anticipated Testimony of Brother Patrick Sopher, Provincial Superior of the South-West Province." No objection has been raised as to hearsay with respect to this exhibit.

> rather than financial has to be a powerful force in arranging one's own priorities. It is extremely important to have this *source* of highest motivation at work among the people each day. [Emphasis in original.]
>
> H. The willingness of the Brothers to lend a helping hand to someone in time of need. The Brothers have shown spiritual support when tragedy strikes a neighbor, such as visiting the ill in hospitals on a consistent basis. Also inviting people who are alone to share a holiday with them. They have sponsored neighborhood gatherings for various occasions. When there is a death in the family, the Brothers had special prayers for us.
>
> I. By their acts of Faith, Hope and Charity they are an inspiration to the community.
>
> J. The warm and generous feeling from all of the very fine men at the farm has served as an example to us in our everyday endeavors. The religious atmosphere, ever present, is a thing, we have observed, many imitate.
>
> K. THEY SHOW A VERY GOOD EXAMPLE OF LIVING A GOOD LIFE. They give food to eat to a few old lonely men from this area who had no one to share important holidays with. A close neighbor of ours has been in the hospital a month and now in a nursing home over a month with a very serious stroke. Many times when we had gone to see our mutual friend, some of the Brothers were there to try to comfort and cheer him. AND IT CERTAINLY HELPED. [Emphasis in the original.]
>
> L. The Brothers of Holy Cross or St. Joseph Farm are always ready to help a neighbor anytime day or night seven days a week. Just give them a call ph 272-0962. Someone will always answer.
>
> M. People in our community are influenced just by the mere religious atmosphere of the St. Joseph Farm. The Brothers are willing to counsel members of our community in problems dealing with family relationships, religious beliefs, as well as any other area in which people are finding it difficult to solve their problems.
>
> N. They've always been ready and willing to help me in any way. They never would take any pay either. I cannot tell all the ways they've helped.
>
> O. I feel that the lifestyle of the Brothers at St. Joseph Farm is a spiritual example to the community. I personally am able to attend mass at St. Joseph Farm especially during Lent when I can't find a Mass elsewhere at the right time. Also, I have always felt free to speak with some of the Brothers about my own personal spiritual needs and thoughts.

There are a total of 167 professed Brothers in the Southwest Province. The numbers of candidates entering the novitiate each year for the last 10 years are as follows:

1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
5	0	1	2	0	3	4	1	4	4

The Southwest Province pays income taxes for those Brothers of the Province who work for organizations which are not exempt from tax under section 501(c)(3).

Not all of the units of the Southwest Province are self-sustaining. Regular financial subsidies are made to several apostolic works in which the Brothers are engaged.

OPINION

Respondent determined that petitioner's farming activity constitutes an unrelated trade or business within the meaning of section 513 and, therefore, determined deficiencies in petitioner's income tax, for taxable years ended June 30, 1977, June 30, 1978, and June 30, 1979, under section 511. Petitioner contests respondent's determination on the following three alternative grounds: (1) The farming activity does not constitute a trade or business within the meaning of section 513; (2) even if the activity is deemed to be a trade or business, the activity was substantially related to petitioner's exempt purposes and therefore does not constitute an unrelated trade or business under section 513; and (3) because substantially all of the farm work was performed without compensation, petitioner's farming activity is not an unrelated trade or business under the exception provided in section 513(a)(1).

Section 511[5] imposes a tax on the unrelated business taxable income of State colleges and universities and of organizations otherwise exempt from tax under section 401(a) and 501(c). Sec. 511(a). "Unrelated business taxable income" is defined by section 512(a)(1) to mean "gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business."

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[5] SEC. 511. IMPOSITION OF TAX ON UNRELATED BUSINESS INCOME OF CHARITABLE, ETC., ORGANIZATIONS.

(a) Charitable, etc., Organizations Taxable at Corporation Rates.—

(1) Imposition of tax.—There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income.".

(2) Organizations subject to tax.—

(A) Organizations described in sections 401(a) and 501(c).—The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c)(1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

(B) State colleges and universities.—The tax imposed by paragraph (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. Such tax shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

(b) Tax on Charitable, etc., trusts.—

(1) Imposition of tax.—There is hereby imposed for each taxable year on the unrelated business taxable income of every trust described in paragraph (2) a tax computed as provided in section 1(e). In making such computation for purposes of this section, the term "taxable income" as used in section 1 shall be read as "unrelated business taxable income" as defined in section 512.

(2) Charitable, etc., trusts subject to tax.—The tax imposed by paragraph (1) shall apply

Section 513(a) defines an "unrelated business trade or business" as follows:

> SEC. 513(a). GENERAL RULE.—The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a)(2)(B), to the exercise or performance of any purpose or function described in section 501(c)(3)), except that such term does not include any trade or business—
>
> (1) in which substantially all of the work in carrying on such trade or business is performed for the organization without compensation; or
>
> (2) which is carried on, in the case of an organization described in section 501(c)(3) or in the case of a college or university described in section 511(a)(2)(B), by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a

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in the case of any trust which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a) and which, if it were not for such exemption, would be subject to subchapter J (sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents).

(c) SPECIAL RULE FOR SECTION 501(c)(2) CORPORATIONS.—If a corporation described in section 501(c)(2)—

(1) pays any amount of its net income for a taxable year to an organization exempt from taxation under section 501(a) (or which would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and

(2) such corporation and such organization file a consolidated return for the taxable year, such corporation shall be treated, for purposes of the tax imposed by subsection (a), as being organized and operated for the same purposes as such organization, in addition to the purposes described in section 501(c)(2).

(d) TAX PREFERENCES.—

(1) ORGANIZATIONS TAXABLE AT CORPORATE RATES.—If an organization is subject to tax on unrelated business taxable income pursuant to subsection (a), the tax imposed by section 56 shall apply to such organizations with respect to items of tax preference which enter into the computation of unrelated business taxable income in the same manner as section 56 applies to corporations.

(2) ORGANIZATIONS TAXABLE AS TRUSTS.—If an organization is subject to tax on unrelated business taxable income pursuant to subsection (b), the taxes imposed by section 55 and section 56 (as the case may be) shall apply to such organization with respect to items of tax preference which enter into the computation of unrelated business taxable income.

> local association of employees described in section 501(c)(4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or
>
> (3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

Section 513(c) provides that "the term 'trade or business' includes any activity which is carried on for the production of income from the sale of goods or the performance of services," and further that "an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization."

The regulations promulgated under section 513 provide the following gloss on the definition of a "trade or business:"

> (b) *Trade or business.* The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. On the other hand, where an activity does not possess the characteristics of a trade or business within the meaning of section 162, such as when an organization sends out low-cost articles incidental to the solicitation of charitable contributions, the unrelated business income tax does not apply since the organization is not in competition with taxable organizations. However, in general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. Accordingly, for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Thus, the term "trade or business" in section 513 is not limited to integrated aggregates of assets, activities and good will which comprise businesses for the purposes of certain other provisions of the Internal Revenue Code. Activities of producing or distributing goods or performing services from which a particular amount of gross income is derived do not lose identity as trade or business merely because they are carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Thus, for example, the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does

> not lose identity as trade or business merely because the pharmacy also furnishes supplies to the hospital and patients of the hospital in accordance with its exempt purposes or in compliance with the terms of section 513(a)(2). Similarly, activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization. However, where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit. [Sec. 1.513-1(b), Income Tax Regs.]

Petitioner's first argument is that the touchstone for determining whether an activity constitutes a trade or business under section 162 is whether the activity was engaged in with a predominant profit motive (*Hirsch v. Commissioner*, 315 F.2d 731 (9th Cir. 1963), affg. a Memorandum Opinion of this Court; *Professional Insurance Agents of Michigan v. Commissioner*, 78 T.C. 246, 262 (1982), affd. 726 F.2d 1097 (6th Cir. 1984)), and that, because petitioner's farming activity is not primarily profit-motivated, the activity does not constitute a trade or business. The question of whether the requisite profit motive exists in any given case is one of fact that is resolved in light of all the facts and circumstances. E.g., *Lemmen v. Commissioner*, 77 T.C. 1326, 1340 (1981).

In support of its contention that the farm is not operated primarily for profit, petitioner cites various operational practices (such as delayed replacement of equipment; failure to use maximum automation; the failure to expand the farm or to borrow money; and loans of equipment, facilities, and the Brothers' time to neighboring farms) and petitioner's accounting practices (failure to use accelerated depreciation or to claim investment tax credits) as "inconsistent with maximizing profits." While petitioner does admit to "some profit motivation" on the part of the Brothers who operate the farm, it maintains that "Any profit motive is clearly subordinate to the primary purpose of farming as the best and perhaps only effective vehicle for conducting an apostolate among farmers."

We do not accept petitioner's argument. In our view, petitioner's analysis goes astray by equating a profit motive with a profit-maximizing motive. The mere fact that a trade or business may not be run as efficiently as possible does not negate the activity's status for tax purposes as a trade or business. The question of whether an activity is conducted primarily for profit requires an evaluation of whether the profit motive predominates over any other motive for engaging in a particular activity (such as personal enjoyment or advancing an exempt purpose). Despite petitioner's assertions that it primarily engaged in farming as a vehicle for advancing its religious, educational, and charitable purposes, we think that the record before us is to the contrary.

To begin with, petitioner has stipulated that the reason that it was given to the Southwest Province in 1955, when the Congregation of the Holy Cross divided the U.S. province into three separate provinces, was to provide the Southwest Province with a source of income. In addition, petitioner, as noted above, concedes that a profit motive does play a role in the operation of the farm.

Petitioner's contention that St. Joseph Farms is operated like a family farm rather than a commercial farm poses, in our view, a distinction without a difference since both a family farm and a commercial farm are for-profit activities. Indeed, we think the record shows that petitioner's operation of St. Joseph Farms is indistinguishable from the operation of any other for-profit farm. The scale of petitioner's operations, the marketing of the farm products, and petitioner's participation in Government-sponsored farm subsidy programs are all factors militating toward the conclusion that the farm was operated for profit. This conclusion is bolstered by the further facts that the Brothers charged with the farming operation performed their duties on a full-time basis, and that assistance to the community (such as the free advice and use of equipment) was done on an informal, ad hoc basis.[6] The law is quite clear that "an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization." Sec. 513(c); sec. 1.513–1(b), Income Tax Regs.

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[6] Petitioner, on brief, contends that the farm operation served an educational purpose. The record, however, is barren of any suggestion that petitioner conducted any agricultural education programs. We fail to find any support in the record for the contention that the farm served as an educational model, and we note that none of the written responses to the community survey attest to the fact that any neighboring farmer has improved his farming methods as a result of his acquaintance with petitioner's farming operations.

Having decided that petitioner's farming operation constituted a trade or business, we turn to the next step in the analysis: whether the trade or business was unrelated to petitioner's exempt purposes. The regulations describe the type of relationship required to take an activity out of the "unrelated" category as follows:

> Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved. [Sec. 1.513-1(d)(2), Income Tax Regs.]

Petitioner contends that the requisite substantial relationship is satisfied in this case, because the operation of the farm provides the setting for its mission of conducting an apostolate within a farming community and establishes credibility for the members of the order within that community. Indeed, petitioner maintains that the Brothers operate a farm for the same reason that they operate schools, boys' homes, and foreign mission facilities, and that the farm would not be operated were it not for the farming apostolate. Through farming, petitioner argues, petitioner propagates moral principles, and the Brothers' "overall lifestyle" teaches moral values to those with whom the Brothers come in contact. As evidence of this assertion, petitioner points to the community survey.

Respondent maintains, and we agree, that there is nothing particularly unique about farming that can "contribute importantly" to the Brothers' religious outreach mission. We think petitioner's equation of the farming operation with its operation of schools, boys' homes, and foreign mission facilities is inaccurate. Clearly, the latter activities fall within the category of what have traditionally been considered, in and of themselves, charitable activities. Farming, on the other hand, does not fall within that category.

While the community survey attests to the fact that the Brothers' "overall lifestyle" teaches moral values to those with whom the Brothers have come in contact, there is nothing in the survey or elsewhere in the record to support a conclusion that there is a substantial relationship between the farming "lifestyle" chosen by the Brothers and the propagation of moral values. We have no doubt that a survey taken in a community in which the Brothers are engaged in any other endeavor would evoke similar responses. Nothing in the survey, as we view it, establishes the requisite nexus between farming and moral teaching.

Petitioner has adduced no evidence to support its assertion that the operation of the farm is *the best or most effective method* for providing both a forum and credibility for the Brothers within the farming community. To adopt this argument, without any proof thereof, would, as respondent points out, imply that a religious group could carry on virtually any business and claim that it was carrying on an apostolic mission to others engaged in that business. Thus, we conclude that petitioner's farming activity is an unrelated trade or business.

The final issue to be determined is whether petitioner fits within the exception to the definition of an unrelated trade or business set forth in section 513(a)(1). Section 513(a)(1) provides that the term "unrelated trade or business" does not include any trade or business "in which substantially all the work in carrying on such trade or business is performed for the organization without compensation." See sec. 1.513–1(e), Income Tax Regs.

In *Waco Lodge No. 166, Benevolent & Protective Order of Elks v. Commissioner*, T.C. Memo. 1981–546, affd. per curiam 696 F.2d 372 (5th Cir. 1983), this Court held that the bingo games operated by an exempt organization did not fall within section 513(a)(1) where 23.1 percent of the work was performed for cash compensation and the balance of the work was performed by "volunteers" who received free drinks for their services. In affirming this Court's opinion, the Fifth Circuit held that, although the free drinks did not constitute compensation to the volunteers for the purposes of the statute, the 23.1 percent of the work performed for cash compensation was substantial enough to disqualify the bingo game operation from the benefit of the exception.

There is no dispute herein as to the facts that approximately 94 percent of the total hours worked in operating the farm and 91 percent of the labor is supplied by the Brothers and that the balance is provided by paid outside workers. Respondent argues, however, that the food, clothing, shelter, and medical care received by the Brothers who operate the farm should be treated as compensation within the meaning of section 513(a)(1). As support for this characterization, respondent relies upon the election by the Southwest Province under section 3121(r) to make FICA payments for the Brothers and upon the characterization of the Brothers' living expenses as "salary" on petitioner's financial statement. We do not agree.

While compensation is unquestionably a broad concept (*Smith-Dodd Businessman's Association, Inc. v. Commissioner*, 65 T.C. 620, 624 (1975)), and embraces non-cash remuneration (e.g., *Commissioner v. LoBue*, 351 U.S. 243 (1956)), we think that a critical element of the concept is that there must be a "but-for" connection between the payment and the services. All of the Holy Cross Brothers, who are under a vow of poverty, are provided with necessities by the Order, without regard to the Brother's particular assignment among the Province's works. Brothers who are disabled, elderly, or attending school receive the same support as those Brothers who are assigned to operating the farm. If St. Joseph Farms were to cease operations tomorrow, we have no doubt that the Brothers who have been operating the farm would receive the same support allowance. This is simply not a case where, but for the rendering of services, the payment would not have been made. We conclude that the support provided those Brothers who operate the farm does not constitute compensation, at least for the purposes of section 513(a)(1), and therefore hold that the exception provided in that provision applies to petitioner's farming activity.

Accordingly,

Decision will be entered for the petitioner.

ESTATE OF NELLE W. KINCAID, DECEASED, JANE K. JOHNSON AND JOAN D. KINCAID, COEXECUTRICES, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 21316-81. Filed July 3, 1985.

W's husband (H) included in his will a formula maximum marital deduction bequest. After the death of H in 1975, W received certain payments which constitute income in respect of a decedent (IRD) as part of her marital share. The IRD is includable in W's income tax return. Sec. 691(c), I.R.C. 1954, provides for an income tax deduction for estate tax attributable to IRD. A necessary step in computing the amount of this deduction is the recomputation of H's estate tax without including the IRD. *Held*, the full maximum marital deduction subject only to the 50-percent limitation pursuant to sec. 2056 is allowable in the recomputation of H's estate tax.

Paul E. Sullivan, for the petitioner.
Andrew M. Winkler, for the respondent.

OPINION

CLAPP, *Judge*: Respondent determined a deficiency in Nelle W. Kincaid's income tax for 1976 of $98,864.18 and a deficiency in her income tax for 1977 of $223,080.75. Because of concessions by both parties, the only issue for our determination is the proper method of computing the deduction under section 691(c)[1] for estate tax attributable to income in respect of a decedent where there is a formula maximum marital deduction bequest.

This case was submitted under Tax Court Rule 122. The stipulations and attached exhibits are incorporated herein by this reference. Nelle W. Kincaid (hereinafter Mrs. Kincaid) resided in Lexington, Kentucky, when her petition was filed.

Mrs. Kincaid was the widow of Garvice Kincaid, who died on November 21, 1975. Mrs. Kincaid died during the pendency of these proceedings, and her estate was substituted as party petitioner. Mr. Kincaid's employment contract with Kentucky

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[1] All references to sections are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

Finance Co. (KFC) provided that his annual bonus payments were to continue after his death and were to be paid to Mrs. Kincaid. The value of the right to the KFC payments was includable in Mr. Kincaid's gross estate and was eligible for the marital deduction provided by section 2056(a).

Most of Mr. Kincaid's other property was bequeathed to a trust. After payment of taxes, debts, and the expenses of administering his estate, the trust property was divided into a "marital part" and a "nonmarital part." The "marital part" consisted of property equal in value to the maximum deduction allowable to his estate less the value of non-trust property includable in his gross estate which passed to Mrs. Kincaid and qualified for the marital deduction. The KFC payments were such non-trust property. Thus, the value of the right to the KFC payments was subtracted from the maximum marital deduction in determining the "marital part." The "marital part" passed to Mrs. Kincaid and was eligible for the marital deduction. The "nonmarital part" consisted of the remainder of the trust property. From the notice of deficiency in the estate tax for Mr. Kincaid's estate and from his estate tax return, there can be no dispute that there were other assets in his estate which would have qualified to fund "the marital part" which were not income in respect of a decedent.

Mrs. Kincaid received $153,120.41 in 1976 and $237,011.63 in 1977 pursuant to the KFC contract. She did not report all of those payments on her income tax returns for those years. The parties now agree that the payments are income in respect of a decedent (IRD) and are includable in Mrs. Kincaid's gross income under section 691(a). They disagree, however, about the amount of the deduction allowable to her under section 691(c)(1)(A)[2] as a consequence of including the KFC payments in her gross income.

The section 691(c)(1)(A) deduction is computed by creating a fraction in which the numerator is the IRD received by Mrs.

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[2] SEC. 691(c). DEDUCTION FOR ESTATE TAX.—

(1) ALLOWANCE OF DEDUCTION.—

(A) GENERAL RULE.—A person who includes an amount in gross income under subsection (a) shall be allowed, for the same taxable year, as a deduction an amount which bears the same ratio to the estate tax attributable to the net value for estate tax purposes of all the items described in subsection (a)(1) as the value for estate tax purposes of the items of gross income or portions thereof in respect of which such person included the amount in gross income (or the amount included in gross income, whichever is lower) bears to the value for estate tax purposes of all the items described in subsection (a)(1).

Kincaid during the year and included in her income and in which the denominator is the value of all IRD included in Mr. Kincaid's gross estate. That fraction is multiplied by the estate tax attributable to all IRD included in his gross estate. The result is the section 691(c)(1)(A) deduction. *Chastain v. Commissioner*, 59 T.C. 461, 464 (1972); *Findlay v. Commissioner*, 39 T.C. 580 (1962), affd. on this issue 332 F.2d 620 (2d Cir. 1964).

The focus of the controversy here is how to calculate the estate tax attributable to the KFC payments pursuant to section 691(c)(2)(C).[3] This section defines the amount of estate tax attributable to the KFC payments to be the difference between the actual estate tax and the estate tax computed without including the KFC payments in the gross estate (recomputed tax). Thus, one must recompute the estate tax by excluding from the value of the gross estate the value of the KFC payments. The heart of the dispute is the effect the exclusion of the KFC payments has on the recomputed marital deduction.

Respondent, relying on Rev. Rul. 67-242, 1967-2 C.B. 227, which in turn relies on section 1.691(c)-1(a)(2), and section 1.691(d)-1(e), example (2), Income Tax Regs., contends that the proper method of recomputation is to subtract from both the gross estate and the marital deduction the KFC payments. This method produces a marital deduction less than the maximum allowed by the 50 percent of the adjusted gross estate limitation.[4] It also produces no change in the taxable estate, because the reduction in the gross estate is equaled by the reduction in the marital deduction and, therefore, the estate tax remains the same. Petitioner contends that the full maximum marital deduction subject only to the 50 percent of adjusted gross estate limitation should be allowed in recomputing the estate tax. Petitioner relies on the testamentary documents which call for a maximum marital deduction bequest based on a formula and on the fact that there are sufficient non-IRD assets in the estate to fully fund this formula marital deduction.

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[3] SEC. 691(c). DEDUCTION FOR ESTATE TAX.—

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(2) METHOD OF COMPUTING DEDUCTION.—For purposes of paragraph (1)—

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(C) The estate tax attributable to such net value shall be an amount equal to the excess of the estate tax over the estate tax computed without including in the gross estate such net value.

[4] Under sec. 2056(c) as in effect during the year in question, the maximum marital deduction was limited to 50 percent of the value of the adjusted gross estate.

This section was repealed by the Economic Recovery Tax Act of 1981, Pub. L. 97–34, 95 Stat. 301, sec. 403(a)(1)(A), applicable to estates of decedents dying after Dec. 31, 1981, thus allowing an unlimited marital deduction. If the unlimited marital deduction is used, there is no tax on the estate of the first spouse to die (and thus no reduction in tax in the recomputation) and no marital deduction in the estate of the last to die (because there is no surviving spouse). Thus, the dispute presented in this case would not arise.

As the following table shows, these approaches produce substantially different results:

	Actual[8] *computation*	*Petitioner's recomputation*	*Respondent's recomputation*
Gross estate	$1,000,000	$900,000	$900,000
Adjusted gross estate	1,000,000	900,000	900,000
Marital deduction	(500,000)	(450,000)	400,000
Exemption	(60,000)	(60,000)	(60,000)
Taxable estate	440,000	390,000	440,000
Estate tax	126,500	100,500	126,500
Sec. 691(c)(1)(A) deduction	- - -	16,000	0

The purpose behind section 691 is to provide a deduction to those required to include IRD in their gross income to offset, at least in part, the estate tax which was attributable to the inclusion of that IRD in the gross estate of a decedent. S. Rept. 1622, 83d Cong., 2d Sess. 87–89 (1954); H. Rept. 1337, 83d Cong., 2d Sess. 64–65 (1954); *Estate of Sidles v. Commissioner*, 65 T.C. 873, 883 (1976), affd. without published opinion 553 F.2d 102 (8th Cir. 1977). Although there is no guidance in the statute or the legislative history on the specific point at issue here, we conclude that petitioner's method is consistent with the purpose of the statute. The formula bequest here required that Mrs. Kincaid receive property equal in value to the maximum marital deduction out of the assets of the estate available for distribution. In the recomputation there is no IRD available in the recomputed gross estate to satisfy the marital bequest. The bequest, therefore, by its own terms, must be funded to its full extent by non-IRD property.

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[8] The tax on Mr. Kincaid's estate is disputed and is pending before the Court in docket No. 15773–79. Because the estate tax case is unresolved, we use the following assumptions to illustrate the difference between the parties' approach: (1) The actual gross estate was $1 million; (2) the actual adjusted gross estate was $1 million; (3) the actual marital deduction was $500,000; (4) the right to the KFC payments was worth $100,000, and was the only item of income in respect of a decedent in the gross estate.

This method fits more logically into the scheme of the statute. The value of KFC payments was included in Mr. Kincaid's estate and taxed there. Even though the payments went to the marital share, there were other assets which could have funded the marital share to fully fund the formula maximum marital deduction bequest. The other assets which were allocated to the nonmarital share were subject to tax. The important fact is that the existence of the IRD produced additional estate tax on Mr. Kincaid's estate. The allocation of assets as between marital and nonmarital shares should be irrelevant to the discussion. Therefore, logically, it must be concluded that the surviving spouse is entitled to some deduction for the excess estate tax paid because of the inclusion of the IRD in the estate. This conclusion should not be nullified by the happenstance that the IRD passed to the marital share rather than the nonmarital share.

Respondent relies on Rev. Rul. 67–242, 1967–2 C.B. 227, which in turn relies on section 1.691(c)–1(a)(2), Income Tax Regs. Initially, we note that revenue rulings represent only the conclusions of respondent and do not have the force and effect of a Treasury regulation. *Helvering v. New York Trust Co.*, 292 U.S. 455 (1934). Moreover, the revenue ruling involves a specific marital bequest rather than a formula bequest. Respondent also relies on section 1.691(d)–1(e), example (*2*), in the regulations which assumes that the only qualifying gift to the spouse is an annuity, a portion of which constitutes the IRD. The example does not specifically address the issue of the recomputed marital deduction but rather is used to illustrate the application of section 691(d) involving a joint and survivor annuity contract. Neither the revenue ruling nor the example in the regulations should control the result of this case which involves a formula maximum marital deduction bequest. Our holding is entirely consistent with section 1.691(c)–1(a)(2), Income Tax Regs., which provides:

> In computing the estate tax without including the [income in respect of a decedent] in the gross estate, any estate tax deduction (such as the marital deduction) which may be based upon the gross estate shall be recomputed so as to take into account the exclusion of the [income in respect of a decedent] from the gross estate.

Under our method, the marital deduction does not include IRD and is also limited to 50 percent of the recomputed gross estate, as required by section 2056.

Respondent also relies on dicta in *Chastain v. Commissioner*, *supra*. That case involved the recomputation of the tax on an estate which was distributed as follows: first, $1 million, which was paid in part out of IRD to the decedent's son; second, several other specific bequests; and third, the residue to a charitable foundation. The Court found that the correct recomputation under section 691(c)(2)(C) required the elimination of the IRD from the gross estate without otherwise changing the amount of the residuary bequest that was actually paid to the foundation. In that case, respondent relied on Rev. Rul. 67-242 and section 1.691(c)-1(a)(2) and example (2) in section 1.691(d)-1(e), Income Tax Regs., to support his argument that the residuary bequest should be recast to account for the exclusion of the IRD which passed to the son. The Court in rejecting the relevancy of the ruling and the regulations to the case at hand stated that "[the] recomputation * * * assumes as fact only the elimination of the section 691 items; there is no assumption of any modification of any gift to the surviving spouse (except to the extent that a 691 item may have been part of the bequest to that spouse)," and all statutory rules "governing the determination of the amount of the marital deduction" apply in the recomputation of the tax. 59 T.C. at 467-468. Respondent relies on this language to support his argument. However, neither the revenue ruling nor the regulations address the problem of a formula maximum marital deduction bequest. The facts in *Chastain* did not involve such a bequest, and the Court recognized that the marital deduction situation is different from the case presented before it:

> It is * * * fallacious to treat the residuary charitable bequest as comparable to the marital deduction. The marital deduction involves merely a *computation* based upon certain assumed facts. The charitable deduction, on the other hand, depends upon the amount actually bequeathed to the charitable beneficiary * * *. [59 T.C. at 468; emphasis in original.]

Therefore, we do not believe our holding is inconsistent with the holding in *Chastain*.

It is not clear from the record whether an issue still exists with respect to income in respect of a decedent which may have passed to someone other than petitioner, and its effect on the section 691(c)(1)(A) deduction. If there are such items of IRD, they should be taken into account in computing Mrs. Kincaid's section 691(c)(1)(A) deduction. *Findlay v. Commissioner, supra.*

Decision will be entered under Rule 155.

JOHN McINTOSH, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 21618–81. Filed July 16, 1985.

Petitioner and his former wife, Jean, were divorced in Montana in 1978. Petitioner transferred appreciated ranch land to his former wife pursuant to a property settlement agreement incident to the divorce. *Held,* the transfer was in the nature of a division of property and was not a taxable transfer.

Lane M. Hauge and *Lynn M. Seelye,* for the petitioner.
Richard Jones and *J.A. Lopata,* for the respondent.

OPINION

CLAPP, *Judge*: Respondent determined a deficiency in petitioner's Federal income tax for the year 1978 in the amount of $129,398. After concessions, the sole issue for decision is whether the transfer of a one-half interest in appreciated ranch land by John McIntosh to his former wife pursuant to a divorce settlement agreement is a taxable event.

This case was submitted fully stipulated pursuant to Rule 122, Tax Court Rules of Practice and Procedure. The stipulation of facts and attached exhibits are incorporated herein by reference.

Petitioner John McIntosh resided in Havre, Montana, at the time his petition was filed. Petitioner was married to Jean McIntosh (hereinafter referred to as Jean or former wife) on July 22, 1954. Shortly thereafter, on September 17, 1954, petitioner executed a contract for deed, acquiring an equitable fee interest in the Phillips Place, a tract of land containing 2,120 acres and costing $78,000. The title to the Phillips Place was held by petitioner in his name, alone. During the course of their marriage, petitioner's wife helped petitioner work the farm and ranch, cooked for him and the other farm workers, raised the couple's four children, and maintained the family home.

On October 17, 1978, a petition for dissolution of marriage was filed by Jean McIntosh. On or shortly after October 17, 1978, petitioner and his former wife entered into a property settlement agreement. This agreement states in pertinent part:

> IV.
>
> The Parties are the owners of certain real and personal property which has been acquired both prior to and since their marriage through the efforts of both Parties. The Parties further declare to each other that they have fully disclosed to the other the complete nature, description and extent of all property interests acquired in their individual and in their joint names, both prior to and since the date of their marriage and in which they have a present legal, equitable or beneficial ownership interest; and the Parties are each aware of the encumbrances and liabilities affecting their farm and ranch properties and the extent of their personal liability in connection therewith; and in consideration of the agreements herein contained, it is mutually agreed that the property of the Parties hereto shall be divided and finally distributed as follows:
>
> * * * * * * *
>
> 4. In lieu of alimony, support and maintenance, the Wife, Jean D. McIntosh, is to receive and retain ownership of an undivided one-half (½) interest in approximately 2,760 acres of farm and ranch lands. * * * [I]t is understood the Wife will lease her interest in said lands to the Husband, John S. McIntosh, for a term of ten (10) years, on a one-fourth (¼) crop share basis, with a minimum share guarantee of at least 3,000 bushels per year to be delivered in the Elevator in the Wife's name.

On October 25, 1978, petitioner, pursuant to the above agreement, tranferred an undivided one-half interest in 1,800 acres of the Phillips Place to his wife. Petitioner and his wife were divorced by decree of dissolution of marriage, dated November 13, 1978. The court stated in the decree that both parties were able-bodied persons, capable of working and earning sufficiently to meet their needs, and neither required any support from the other. The property agreement was incorporated as part of the decree.

In the notice of deficiency, the Commissioner included, among other adjustments, an amount of capital gain as a result of the transfer of the ranch land from petitioner to his former wife.

After concessions, the sole remaining issue in this case is whether petitioner's transfer of the undivided one-half interest in ranch land to his former wife, Jean, pursuant to a property settlement agreement, executed in connection with their divorce, constitutes a taxable disposition.

The leading case on this issue, applicable to the transfer herein, is *United States v. Davis*, 370 U.S. 65 (1962).[1] The taxpayer-husband transferred appreciated stock to his former wife pursuant to a voluntary property settlement agreement, incorporated into the divorce decree. Under Delaware law, the stock transferred was that of the husband, subject to certain marital rights of the wife, including a right of intestate succession and a right upon divorce to a share of the husband's property. The taxpayer argued that the transfer was comparable to a nontaxable division of property between two co-owners while respondent contended that it more resembled a taxable transfer of property in exchange for the release of an independent legal obligation. The Supreme Court, in finding the transfer to be a taxable event, stated:

> the inchoate rights granted a wife in her husband's property by the Delaware law do not even remotely reach the dignity of co-ownership. The wife has no interest—passive or active—over the management or disposition of her husband's personal property. Her rights are not descendable, and she must survive him to share in his intestate estate. Upon dissolution of the marriage she shares in the property only to such extent as the court deems "reasonable."* * * Regardless of the tags, Delaware seems only to place a burden on the husband's property rather than to make the wife a part owner thereof. In the present context the rights of succession and reasonable share do not differ significantly from the husband's obligations of support and alimony. They all partake more of a personal liability of the husband than a property interest of the wife. * * * Although admittedly such a view may

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[1] The Tax Reform Act of 1984, Pub. L. 98-369, sec. 421, 98 Stat. 793, added a new Internal Revenue Code sec. 1041 which provides that no gain or loss will be recognized on a transfer of property from an individual to a former spouse incident to a divorce. This section, which effectively overrules the *Davis* decision, applies to transfers made after July 18, 1984, with some exceptions not applicable in this case. Hereinafter, unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect in the tax year in issue.

> permit different tax treatment among the several States, this Court in the past has not ignored the differing effects on the federal taxing scheme of substantive differences between community property and common-law systems. [370 U.S. at 70–71.]

Petitioner in this case argues that, in accordance with the Supreme Court's opinion in *Davis*, State law should be consulted to determine the nature of Jean's interest in the property. Under Montana law, Jean had a vested interest in the ranch land property. Therefore, the transfer constitutes a division of property between co-owners and is a nontaxable event.

On the other hand, respondent argues that the question of the taxability of a transfer of appreciated property in connection with a divorce is a Federal question to be decided by Federal courts using Federal criteria. Respondent contends that considering the rights granted a spouse by Montana law and evaluating those rights in light of the *Davis* criteria, e.g., descendible rights, management of property, the transfer of the property in the instant case more resembles a taxable transfer of property in exchange for the release of an independent legal obligation than it resembles a nontaxable division of property between two co-owners.

The key question presented in this case then is what is the nature of the former wife's interest, if any, in the ranch land and what criteria should be used to determine that interest.

In determining the criteria, we note the well-settled principles that State law creates legal interests and rights. Federal law determines what transactions involving interests or rights created by State law should be taxed. *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940). In determining ownership of property, State law controls. *United States v. Mitchell*, 403 U.S. 190, 197 (1971).

Respondent has argued previously that the *Davis* case established Federal criteria by which to determine whether a former spouse has a sufficient property interest to characterize as co-ownership. Respondent's argument has been rejected, in particular, in the series of *Collins* cases. The issue there was whether the transfer of property, which was held in the husband's name only, to his former wife pursuant to a property settlement agreement was a taxable event. The pertinent Oklahoma statute provided:

> As to such property, whether real or personal, as shall have been acquired by the parties jointly during their marriage, whether title thereto be in either or both of said parties, the court shall make such division between the parties respectively as may appear just and reasonable, by a division of the property in kind, or by setting the same apart to one of the parties, and requiring the other thereof to pay such sum as may be just and proper to effect a fair and just division thereof. [Okla. Stat. Ann. tit. 12, sec. 1278 (West 1961).]

The Tax Court in *Collins v. Commissioner*, 46 T.C. 461 (1966), found that under Oklahoma law, property acquired jointly during marriage was similar to the concept of community property. However, the former spouse had no vested interest in jointly acquired property separately held by the other spouse prior to an action by a court incident to a petition for divorce. *Davis* was referring to property jointly owned, that is title held jointly, or community property. Because neither category applied, the Court found the transfer taxable. In *Collins v. Commissioner*, 388 F.2d 353 (10th Cir. 1968) (hereinafter referred to as *Collins I*) the Tenth Circuit agreed with the Tax Court that the transfer was taxable. The court stated that *Davis* required an examination of the State law controlling the disposition of the property to determine the exact nature of the disposition. It found that the tenor of the Oklahoma cases dealing with the relevant statute was that the division is of jointly owned property and is to be considered separately from the husband's obligations of alimony and support and maintenance. "[I]t appears that the division of jointly acquired property pursuant to a divorce decree in Oklahoma is in many instances in direct recognition of the wife's right to a share in the property." (388 F.2d at 57.)

However, the Court went on to conclude the following:

> whatever the nature of the rights granted by Oklahoma law to spouses in jointly acquired property it is clear they do not include the traditional ownership rights in property. These rights such as descendible interest, right to control and disposition of property and vested interest are set out by the Supreme Court in United States v. Davis, supra, as factors that distinguish a marital division in satisfaction of a legal obligation from a division between co-owners. Since these traditional elements of co-ownership are lacking the fact that in making a decision the state courts speak as though they were dividing property between co-owners does not prevent the federal courts from saying that for tax purposes the division was in satisfaction of a marital obligation and thus taxable. [388 F.2d at 357–358.]

The Oklahoma Supreme Court 7 months later in *Collins v. Oklahoma Tax Commission*, 446 P.2d 290 (Okla. 1968) (hereinafter referred to as *Collins II*), considered precisely the same facts involving the same parties but the question was whether the transfer of stock was taxable under the State income tax code. The Oklahoma Tax Commission had found the transfer taxable based upon the rules announced by the Tenth Circuit in *Collins I.* However, the Oklahoma Supreme Court found that the Tenth Circuit opinion was not controlling on the State authority and disagreed with the Tenth Circuit's interpretation of Oklahoma law. The court found that under Oklahoma law, "The nature of the wife's interest is similar in conception to community property* * *, and is regarded as held by a species of common ownership." (446 P.2d at 295.) The court, in rejecting the applicability of the *Davis* case, stated that under Oklahoma law:

> neither the actual investiture of title, a right to make present disposition of property, nor absence of a descendible interest are controlling. A wife has a vested interest in jointly acquired property of the marital community. [446 P.2d at 297.]

One month later, the Supreme Court, acting on Mr. Collin's petition for writ of certiorari from *Collins I*, vacated the judgment and remanded the case to the Court of Appeals for further consideration in light of the opinion of the Oklahoma Supreme Court in *Collins II. Collins v. Commissioner*, 393 U.S. 215 (1968) (hereinafter referred to as *Collins III*).

On remand, the Tenth Circuit in *Collins v. Commissioner*, 412 F.2d 211 (10th Cir. 1969) (hereinafter referred to as *Collins IV*) stated:

> Having the benefit of an interpretation of state law on this very point, we must conclude that the stock transfer operated merely to finalize the extent of the wife's vested interest in property she and her husband held under "a species of common ownership." [412 F.2d at 212.]

The Tenth Circuit rejected respondent's argument that Federal criteria were established in *Davis*, e.g., right of control, descendible interest: "The [Supreme] Court merely discussed certain general characteristics of co-ownership in an attempt to determine whether the wife possessed the rights of a co-owner under state law." (412 F.2d at 212.) Because the

Oklahoma Supreme Court determined that the wife was a part owner, "there is no need to search state law for indications of other factors that might signify the nature of the wife's property interest." (412 F.2d at 212.)

In *Imel v. United States*, 375 F. Supp. 1102 (D. Colo. 1973), the United States District Court in Colorado was faced with the same issue of whether a transfer of appreciated property pursuant to a court-approved divorce settlement was taxable. The court said it had difficulty in determining the precise nature of the wife's interest in the property and, therefore, the court made a certification to the Colorado Supreme Court requesting its interpretation of Colorado law on this issue. The Colorado Supreme Court held that at the time the divorce action was filed, there vested in the wife her interest in the property in the name of the husband. In *In re Questions Submitted by United States District Court*, 517 P.2d 1331 (Colo. 1974), the court perceived no material distinction between the statutes in Colorado and those of Oklahoma considered in the *Collins* cases. The transfer was a recognition of a "species of common ownership" of the marital estate by the wife resembling a division of property between co-owners. The court recognized that:

> During the marriage, and absent any divorce action, the parties have their separate property and, possibly subject to an exception or two, can dispose of it as he or she desires. * * *
>
> However, at the time of the filing of the dissolution action in which the division of property will be later determined, a vesting takes place.
> [517 P.2d at 1335.]

The U.S. District Court concluded that *Davis* and *Collins IV*, when coupled with the Colorado Supreme Court's answers to the certified questions, mandated a judgment in favor of the taxpayer that the transfer was nontaxable. *Imel v. United States, supra* at 1118.

The Tenth Circuit in *Imel v. United States*, 523 F.2d 853 (10th Cir. 1975), affirmed the District Court concluding that *Davis* did not establish Federal criteria in determining the nature of the pre-transfer right in the property. It further stated:

> In applying Delaware law in *Davis* the Court did not define the time when the interest of the wife had to vest. The Court refers to the interest of the

> wife "[u]pon dissolution of the marriage." * * * Both the Oklahoma and Colorado courts said that the vesting occurred at the time of the filing of the divorce suit. [523 F.2d at 856.]

The court distinguished two other Tenth Circuit cases, *Wiles v. Commissioner*, 499 F.2d 255 (10th Cir. 1974), and *Hayutin v. Commissioner*, 508 F.2d 462 (10th Cir. 1974). In *Wiles*, the 10th Circuit held that under Kansas law, the wife had no vested rights at the time of transfer. In *Imel*, the court found *Wiles* was not controlling because it involved Kansas law as opposed to Colorado law. In *Hayutin*, the issue was whether 7 monthly payments made by the husband to the wife pursuant to a property settlement agreement were taxable to the wife under section 71 as alimony or whether they were nontaxable as a property division. The Tenth Circuit found that Colorado divorce laws did not make the wife a co-owner of the property but rather placed a burden on the husband's property, therefore, the payments were taxable as satisfaction of a marital obligation. In *Imel*, decided 9 months later, the Tenth Circuit distinguished *Hayutin* on the basis that it involved different Code provisions. The court concluded that in view of the Colorado Supreme Court's decision that the wife had a vested interest in the property at the time of the divorce action, the transfer was not taxable.

Respondent argues that to allow the State courts to define the interests of former spouses as "species of common ownership" bestows on States the power to override the Federal tax system. Respondent points to Kansas and Oregon statutes which were amended in reaction to adverse court decisions which found that the respective pre-amended State statutes did not confer a vested interest on the non-title-holding spouse. According to respondent, the subsequent amendments did not change the nature of the substantive property interests of the spouses but simply labeled the property interests as "species of common ownership" in order to avoid the application of *Davis*.

Even if we accepted respondent's interpretation of these statutes, it is irrelevant in the instant case which is not concerned with Kansas or Oregon law. Respondent has not argued, nor could he, that the pertinent Montana statutes, as discussed *infra*, were enacted in response to adverse court decisions. It is well-settled that States have the power to determine property interests. *United States v. Mitchell, supra*.

Davis and its progeny, such as the *Collins* cases and *Imel*, make it clear that an examination of State law is required. Respondent states that this Court and other courts have taken the approach of evaluating State law in light of the *Davis* criteria, citing *McKinney v. Commissioner*, 64 T.C. 263 (1975); *Eblen v. Commissioner*, T.C. Memo. 1982–448, affd. 736 F.2d 1100 (6th Cir. 1984); *Dunn v. Commissioner*, T.C. Memo. 1977–156; and *Forbes v. Massachusetts*, 472 F. Supp. 840 (D.Mass. 1979). However, these cases do look to State court determinations. Having done so, they conclude that the State does not recognize a property interest resembling co-ownership.

In *Cook v. Commissioner*, 80 T.C. 512 (1983), affd. without published opinion 742 F.2d 1431 (2d Cir. 1984), this Court considered Connecticut State court decisions and the testimony of the presiding divorce court judge and concluded that under the particular circumstances of that case, the transfer was more in the nature of a division of property. The transfer did not discharge any marital obligations—the transferor husband received nothing in exchange. The divorce court judge believed that the wife had an interest in the property which vested when the marriage dissolved. 80 T.C. at 528. In *Serianni v. Commissioner*, 80 T.C. 1090 (1983), on appeal (11th Cir., Feb. 13, 1984), this Court considered a transfer of stock to the wife which had been held in the husband's name alone. As part of its divorce decree, the divorce court in Florida awarded a special equity interest to the wife in the stock. Florida Supreme Court decisions had found that a special equity constitutes a vested equitable property right. This Court followed the opinion of the Fifth Circuit in *Bosch v. United States*, 590 F.2d 165 (5th Cir. 1979), which held that a special equity interest recognized by the Florida cases differed materially from the property interest involved in *Davis* and that an award of such an interest was not a taxable transaction. See *Mann v. Commissioner*, 74 T.C. 1249 (1980). A reading of these cases makes it clear that one must examine the State law at issue to determine whether there exists a vested property right at the dissolution of the marriage.[2]

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[2] See also *Beard v. Commissioner*, 77 T.C. 1275, 1290 n. 9 (1981) (and cases cited therein); *Lewis v. Commissioner*, T.C. Memo. 1983–770; *Test v. Commissioner*, T.C. Memo. 1984–649.

Montana is not a community property State. Neither husband nor wife has any interest in the property of the other. Under section 40-2-202 of the Montana Code Annotated (1979):

> All the property of a married person owned before marriage and that acquired afterwards is his individual property. The married person may, without consent, agreement, and signature of his spouse, convey and transfer his individual property, real or personal, including the fee simple title to real property, or execute a power of attorney for the conveyance and transfer thereof.

However, in a divorce proceeding, the court is required to equitably apportion the property under section 40-4-202 in effect in 1978 (as derived from the Uniform Marriage and Divorce Act):

> *Disposition of property.* (1) In a proceeding for dissolution of a marriage, legal separation, or disposition of property following a decree of dissolution of marriage or legal separation by a court which lacked personal jurisdiction over the absent spouse or lacked jurisdiction to dispose of the property, the court, without regard to marital misconduct, shall, and in a proceeding for legal separation may, finally equitably apportion between the parties the property and assets belonging to either or both, however and whenever acquired and whether the title thereto is in the name of the husband or wife or both. In making apportionment, the court shall consider the duration of the marriage and prior marriage of either party; antenuptial agreement of the parties; the age, health, station, occupation, amount and sources of income, vocational skills, employability, estate, liabilities, and needs of each of the parties; custodial provisions; whether the apportionment is in lieu of or in addition to maintenance; and the opportunity of each for future acquisition of capital assets and income. The court shall also consider the contribution or dissipation of value of the respective estates and the contribution of a spouse as a homemaker or to the family unit. In disposing of property acquired prior to the marriage; property acquired by gift, bequest, devise, or descent; property acquired in exchange for property acquired before the marriage or in exchange for property acquired by gift, bequest, devise, or descent; the increased value of property acquired prior to marriage; and property acquired by a spouse after a decree of legal separation, the court shall consider those contributions of the other spouse to the marriage, including:
>
> (a) the nonmonetary contribution of a homemaker;
>
> (b) the extent to which such contributions have facilitated the maintenance of this property; and
>
> (c) whether or not the property disposition serves as an alternative to maintenance arrangements.
>
> (2) In a proceeding, the court may protect and promote the best interests of the children by setting aside a portion of the jointly and separately held

> estates of the parties in a separate fund or trust for the support, maintenance, education, and general welfare of any minor, dependent, or incompetent children of the parties.[3]

Under the statute and decisions of the Montana Supreme Court, the source of and title to marital property is irrelevant to the division of such property upon dissolution of the marriage. The courts have the power to divide the property on an equitable basis regardless of where title lies.

The Montana Supreme Court in *In Re Marriage of Brown*, 587 P.2d 361 (Mont. 1978) stated (p. 365):

> The decisions of this Court following the enactment of the Uniform Marriage and Divorce Act declare that as a housewife, the wife acquires a vested interest in the property accumulated by the parties during the marriage.

In that case, the marital assets consisted of ranch property which was inherited by the husband and was in his name, alone. Glenda, his wife, was not employed outside the home but had the homemaking and child raising responsibilities. In addition, she would, as needed, help with the ranch work. The court reviewed several Montana Supreme Court cases decided prior to the Uniform Marriage and Divorce Act which found that a wife's contribution as a homemaker and mother was equivalent to the husband's financial contribution and concluded:

> It is therefore obvious that Glenda acquired a vested interest in the major marital asset, the ranch property, regardless of its source and title. She did so by virtue of her fourteen years as mother, housewife and part-time ranch hand. [587 P.2d at 365.]

The Montana Supreme Court in *In Re Marriage of Jacobson*, 600 P.2d 1183 (Mont. 1979), affirmed the lower court's conclusion that the parties had made equal contributions to the marital estate and that the wife had acquired a vested one-half interest in all property acquired by the parties during their marriage.

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[3] This statute was amended in 1983 to change the references to disposition of property to references to division of property and to add two new subsections. These subsections provide, in general, that each spouse is considered to have a common ownership in marital property that vests immediately preceding the entry of the decree of dissolution and that the apportionment of marital property is a division of common ownership for purposes of the property laws of the State as well as the Federal income tax laws. Because the divorce proceeding in the instant case occurred in 1978, we are concerned with the Montana statute, as quoted above, which was in effect during that year.

In *In Re Marriage of Johnsrud*, 572 P.2d 902 (Mont. 1977), the Montana Supreme Court concluded that the wife acquired a vested interest in the property accumulated by the parties during the marriage and that this interest vested upon dissolution of the marriage. The court recognized a need to distinguish between the property right in the marital estate and the need for maintenance. The divorce court must first equitably distribute the marital property and then look at the need for maintenance. It is the mandatory duty of the court to divide the property although the court has discretion as into what proportions the property will be divided.

These cases all conclude that under Montana law the wife acquires a vested interest in the property accumulated by the parties in marriage. In *Boucher v. Commissioner*, T.C. Memo. 1981-258, affd. 710 F.2d 507 (9th Cir. 1983), this Court was faced with the issue as to whether payments by the husband to his former wife pursuant to a divorce decree were deductible as alimony under section 215. In holding that the payment was a part of a property settlement, this Court examined Montana Supreme Court cases and concluded:

> These cases clearly indicate that in Montana, which is not a community property state, a wife may gain rights to a portion of property legally titled in the name of her husband alone. These property interests will inure as a result of monetary and non-monetary contributions to the acquisition and maintenance of the property titled in the husband's name. [41 T.C.M. 1589, 1593, 50 P-H Memo T.C. par. 81,258, at 81-897.]

In *Boucher v. Commissioner*, 710 F.2d 507 (9th Cir. 1983), the Ninth Circuit, the Circuit to which this case is appealable, in affirming the judgment of this Court, held that the judgment of the Montana State court was controlling where it finally determined the character of the challenged payments after a contested hearing. In a situation where there is no contested hearing, the court noted:

> Where the parties negotiate a property settlement agreement, which is thereafter incorporated into the divorce decree, without an independent determination by the court as to the nature of any payment set forth therein, this court has held that we must look to the laws of the state to resolve any dispute as to the character of any property described in the agreement. [710 F.2d at 512.]

Here, in the context of a transfer of appreciated property, we have looked to Montana State law to determine the property interest of the spouse. Respondent argues, citing *Hall v. Commissioner*, T.C. Memo. 1982-605, that *Boucher* dealt only with the issue of section 71 and that property rights which would support a property settlement in that context will not necessarily constitute co-ownership described in *Davis*. But we think that an examination of the Montana Supreme Court cases shows that Montana law confers the same property interest upon the former spouse as that involved in *Collins* and *Imel* and that this interest vests upon dissolution of the marriage.

Respondent argues that the vesting of the property interest is itself a taxable event. Respondent cites, however, no authority for this proposition. In *Imel v. Commissioner, supra*, the Tenth Circuit noted that *Davis* did not specify when the interest had to vest but that the Supreme Court referred to the interest "upon dissolution of marriage." We agree with petitioner that no sale or exchange takes place at vesting. Vesting is simply a recognition of the former spouse's contribution to property jointly acquired during marriage. There is no release of a personal obligation of the title-holding spouse.

Finally, respondent argues that based on the facts of this case, this transfer was in lieu of a support obligation and not in satisfaction of any property rights. In support of this contention, respondent cites the property settlement agreement, itself, which expressly provides that the transfer was made "in lieu of alimony, support, and maintenance."

The labels attached to payments provided for in a marital settlement agreement or a divorce decree are not controlling. *Beard v. Commissioner*, 77 T.C. 1275, 1283–1284 (1981); *Hesse v. Commissioner*, 60 T.C. 685, 691 (1973), affd. without published opinion 511 F.2d 1393 (3d Cir. 1975). The intent of the parties is an important consideration. *Schottenstein v. Commissioner*, 75 T.C. 451, 456 (1980). To discern this intent, one should look at the agreement in its entirety.

In the preamble of section IV, the agreement provides that—

> The Parties are the owners of certain real and personal property which has been acquired both prior to and since their marriage through the efforts

> of both Parties. * * * it is mutually agreed that the property of the Parties hereto shall be divided and finally distributed as follows: * * *

Thus, the parties intended in this section to divide and distribute the marital assets which include the Phillips Place. In addition, the divorce decree specifically made a finding that no support was required. The agreement and the decree are unambiguous that no support payments are contemplated.

Respondent points to the portion of the agreement which provides that in conjunction with the transfer of the ranch land, the former wife would lease her interest to petitioner for a 10-year period on a one-fourth crop-share basis with a minimum share guarantee of 3,000 bushels per year. Respondent relies on the following four factors listed in *DeSmyter v. Commissioner*, T.C. Memo. 1973–90, which would show that a property settlement, rather than support payments, was intended by the parties: (1) The fact that the payments are not related to the income of the payor spouse; (2) the presence of a fixed sum; (3) the continuation of the payments without regard to the death or remarriage of the payee spouse; and (4) the fact that the payee spouse did relinquish property interests in return for the payments. Respondent argues that the parties fail to meet factors (1), (2), and (4) in that the payments, i.e., the crop share, are related to petitioner's production of land; only a minimum amount of income is set forth, not a fixed sum; and that there is no mention that the former wife relinquished property interests.

Respondent's reliance on *DeSmyter* is misplaced. The issue in *DeSmyter* was whether cash payments made by the husband represented alimony or property settlement. Here, the issue is whether the transfer of an undivided one-half interest in a property is a taxable disposition. If one looks at the property transfer, it is impossible to apply the factors listed above because there are no "payments." Respondent appears to be referring to the crop share. However, these payments are not the issue in this case. These payments are in fact rental payments which are given in consideration of the lease. *England v. Commissioner*, 37 T.C. 1150 (1962).

In conclusion, the parties intended the transfer to be a division of property accumulated by their joint efforts during their marriage. Under Montana law, husband and wife at the dissolution of marriage have a vested interest in property acquired during marriage regardless of which spouse holds title. Therefore, the transfer of this property resembles more a division between co-owners than a release of a legal obligation. Accordingly, the transfer is a nontaxable event.

Because of concessions,

Decision will be entered under Rule 155.

TRIUNE OF LIFE CHURCH, INC., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 11175–83X. Filed July 24, 1985.

Petitioner was formed as a nonprofit corporation, in part, to conduct religious services, to promote the doctrine of Triune of Life, to perform the sacrament of "spinology," to train "spinologists" to conduct the sacrament of spinology, and to maintain and operate spinal tutoriums. Petitioner filed with the Internal Revenue Service an application for recognition of exemption from Federal income tax under sec. 501(c)(3), I.R.C. 1954. The Internal Revenue Service determined that petitioner did not qualify for tax-exempt status. Thereafter, petitioner filed a petition with this Court for declaratory judgment pursuant to sec. 7428. *Held*, petitioner failed to carry its burden of proving that it is operated exclusively for exempt purposes and that no part of its net earnings inures to the benefit of any private individual.

Alvin S. Moses and *Mark C. Schultz*, for the petitioner.

Linda S. Bednarz, for the respondent.

OPINION

STERRETT, *Chief Judge*: This is an action for declaratory judgment under section 7428, I.R.C. 1954. At issue is petitioner's status as a tax-exempt religious organization under section 501(c)(3). Resolution of that issue turns on: (1) Whether petitioner is operated exclusively for exempt purposes; and (2) whether any part of petitioner's net earnings inures to the benefit of any private individual.

Petitioner filed an application with the Internal Revenue Service for recognition of exemption from Federal income tax under section 501(c)(3), claiming therein to be a church.

On February 9, 1983, the Service issued a final adverse determination. The following reasons were given as the basis for said determination:

> (1) You are not operated exclusively for a religious purpose.
>
> (2) You are operated for the private interest of the incorporators and creators.
>
> (3) Your net earnings inure to the benefit of private individuals.

Having exhausted all of its administrative remedies as required by section 7428(b)(2), petitioner has invoked the jurisdiction of this Court for a declaratory judgment pursuant to section 7428.

The parties have filed with the Court the entire administrative record and have stipulated to its genuineness.[1] The stipulated administrative record is incorporated herein by this reference. Our decision will be based upon the assumption that the facts as represented in the administrative record are true for purposes of this proceeding. Rule 217(b)(1), Tax Court Rules of Practice and Procedure.[2]

The Triune of Life Church (petitioner) was incorporated as a nonprofit corporation under the laws of the State of Pennsylvania on December 24, 1979. It is located at 7151 Frankford Avenue, Philadelphia, Pennsylvania.

Petitioner's articles of incorporation originally stated its purposes as follows:

> 1. To form and maintain a congregation committed to the religious doctrine of the Triune of Life.
> 2. To conduct religious services and to perform spineology [sic] and other religious sacraments.
> 3. To study, teach, publish, promote, and practice the doctrine of the Triune of Life.
> 4. To cooperate with other groups and individuals in service to Universal Intelligence and to the Triune of Life.
> 5. To train spineologists [sic] to conduct and perform the sacraments in accordance with the doctrine.

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[1] Petitioner filed a motion to supplement the administrative record. After hearing, the Court denied petitioner's motion.

[2] All Rule references herein are to the Tax Court Rules of Practice and Procedure.

> 6. To maintain and operate instructional institutions, each to be known as a spinal tutoriun [sic] and to ordain as spinologists such persons as are deemed by the Board of Trustees to be qualified.

Petitioner's articles of incorporation were amended on July 7, 1981, to provide, in effect, that (1) no part of its net earnings shall inure to the benefit of any private person; (2) no substantial part of its activities shall consist of carrying on propaganda or otherwise attempting to influence legislation; (3) it shall not engage in any other activity not permitted to be carried on by a corporation exempt from Federal income tax under section 501(c)(3) or by a corporation, contributions to which are deductible under section 170(c)(2); and (4) upon dissolution, assets will be distributed for an exempt purpose recognized under section 501(c)(3).

The founder and president of petitioner is Dr. Reginald Gold, who had written and published a book entitled "Triune of Life," which served as inspiration for the establishment of the doctrine of the church. Dr. Gold had been a practicing doctor of chiropractic and an educator in a chiropractic college.

Petitioner is dedicated to the doctrine of the Triune of Life. That doctrine has three components: intelligence, matter, and force. The sole sacrament currently administered by petitioner is that of spinology. The object of spinology is to restore human beings to harmonious unity of mind, spirit, and body for the fulfillment of life. Petitioner's doctrine teaches that, sometimes, when an individual is spiritually inhibited from expressing his or her full life potential, there is a physical manifestation. Spinology seeks to correct this spiritual problem by the physical sacrament of spinology, which involves a gentle laying of the hands on the person by a certified spinologist. Pamphlets entitled "Open Up Your Life by studing to be a Certified Spinologist then open up the lives of others" and "Dare With Us Care With Us Share With Us explore an exciting new career opportunity as a Certified Spinologist" describe spinology as follows:

> Spinologists envision a world in which people dwell in harmony, and seek to bring this about by helping people express their full life potential.
>
> Spinology is based upon a profound respect for the totality of life and the fact that the nerve system maintains the totality by directing all functions.

> The human body consists of some 25 to 30 quadrillion cells, all working together for the purpose of expressing full life potential. It is obvious that coordination of the thousands and thousands of biological processes necessary to maintain life is dependent upon a control system. The brain, spinal cord and millions of miles of nerve fibers form the control system in human beings.
>
> This magnificent communications network is protected by a framework of solid bone. The brain, enclosed in a housing known as the skull, has extensions reaching out to virtually every organ and tissue in the body. The most vulnerable part of the system is an extension of the brain known as the spinal cord. This vital and vulnerable life-line is housed within 24 movable bones that comprise the spinal column, or "backbone." These spinal bones protect the delicate nerve trunks.
>
> Should a bone of the spine become jarred from its proper position, however, the bones could compress the very nerve trunks they are meant to protect. Such compression interferes with the flow of nerve impulses, and the 25 to 30 quadrillion cells of the body can no longer work together as one functional unit. The individual then is no longer able to express full life potential.
>
> The purpose of spinology is the correction of such interference. The spinologist gently applies the hands to the spine, enabling the body to correct any deviations that interfere with the flow of life energy. This restores the ability of the body to express its full and harmonious life potential.
>
> Only when the human body is thus in harmony with itself can it achieve harmony with others for a better world.

There are four categories of people who play roles in petitioner's organizational scheme:

> A. *Members* (sometimes referred to as "Recipients"): each member receives the sacrament of Spinology and participates in the religious philosophy and doctrinal services of the Church.
>
> B. *Spinologist* (sometimes referred to as "Affiliate"): a Spinologist is a leader of a congregation. The responsibilities of the Spinologist include spreading and sharing the doctrine of the Church, leading services, and administering the sacrament of Spinology to various members of the Church.
>
> C. *Trainee*: a trainee is a Spinologist in training. The Trainee also participates in daily services.
>
> D. *Board of Elders*: This group consists of those Affiliates who have been elected by the corporate members to advise the Church and the public. * * *

One of petitioner's tenets teaches evangelism, which is accomplished primarily through the efforts of the spinologists, who are expected to start and lead their own congregations. A new spinologist may obtain congregants through speaking engagements, advertising, and through the spreading of the faith by fellow congregants. When a potential congregant inquires about membership in any particular spinologist's congregation, the following procedure is always instituted:

> a. The potential congregant is invited to an initiation which will usually take approximately one hour. The potential congregant is urged to bring his or her spouse and all children age twelve or older to participate in this initiation.
>
> b. At the initiation, the congregant is informed of the basic tenets of the Church, and is required to make a commitment to them.
>
> c. The basic purpose of the sacrament of Spinology is also explained to the prospective congregant and each family member. They are further informed that the object of the sacrament is to restore human beings to harmonious unity of mind, spirit, and body for the fulfillment of life; and that the gentle laying of hands on the member's body will help achieve this unity.
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> d. The prospective congregant is informed that membership will require that each member of the family receive the sacrament of the Church initially three times per week and thereafter weekly.
>
> e. The congregant is also informed as to the time and location of monthly doctrinal instructions and religious services which are conducted by the affiliated Spinologist. All members of the family are required to attend, especially those who continue to receive the sacrament of Spinology. The purpose of these monthly services is to orient the new congregant into the philosophy of the Church which affects every aspect of his life. Accordingly, the congregant is informed that attendance at these religious services is a prerequisite to for [sic] the privilege of continuing membership in the congregation.
>
> f. The Spinologist also explains in detail membership dues. For those potential congregants who are in need and cannot afford to pay the usual membership dues, the Spinologist, as part of his or her responsibilities to the Church, will adjust or waive the membership dues provided that the congregant accepts the tenets of the Church and agrees to live according to them.
>
> g. Once admitted into membership, should any member of the Church fail to attend monthly services or sacramental sessions, then he or she may be severed from membership in the Church without further cause.
>
> h. Services conducted by Spinologists resemble "Meetings" of the Society of Friends (Quaker) more than any other large organized religious group. They do not, however, involve communal worship or responsive reading. At each service, some phase of the Church doctrine is explored and expressed, either by the Spinologist conducting the service or by a congregant.

Each spinologist conducts services with his or her own congregation at least once per month. In addition, services are conducted twice daily at petitioner's location at 7151 Frankford Avenue, Philadelphia, Pennsylvania.

Petitioner owns and operates the Philadelphia Spinal Tutorium (Tutorium), a training institution for spinologists. The

Tutorium is located at the same address as petitioner. Dr. Gold is an administrator and instructor at the Tutorium.

To become a spinologist in petitioner's organization, one must successfully complete the training course given by the Tutorium and commit oneself to live by the doctrine of the organization. The training course is a 1-year program of 3 trimesters of 12 weeks each. Classes are conducted twice daily and trainees are given a choice of attending either of the two sessions. Tuition for the training program at the Tutorium is $3,000 per student. A pamphlet published in connection with the program states as follows:

> Philadelphia Spinal Tutorium is an affiliate of the Triune of Life Church, and as such is authorized by the Church to train Spinologists.
>
> Upon satisfactory completion of the course at the Philadelphia Spinal Tutorium, an appropriate certificate of completion is awarded. Holders of this certificate are eligible to become ordained by the Triune of Life Church as Spinologists. * * *

The pamphlet also states:

> Prospective students are advised that the practice of the healing arts in the United States is regulated by licensing laws. Any prospective student seeking to practice a healing arts profession in the United States is advised to enroll not in the Philadelphia Spinal Tutorium, but in an appropriate healing arts school. The Spinology course at the Philadelphia Spinal Tutorium does not prepare its students for licensure in any healing art.

Recipients of the sacrament of spinology are required to pay dues to the spinologist administering the sacrament. A spinologist may adjust or waive such dues for those potential congregants who cannot afford to pay them. Part of a spinologist's agreement to live by petitioner's doctrine is an agreement to pay a tithe to petitioner. Spinologists are exempt from tithing during their first year of practice.

The original capital for funding petitioner's organization was received by loans from Dr. Gold and one Miguel Bolufer, an elder leading a congregation in Spain. The loans were in the amounts of $45,000 and $32,169, respectively, and carried simple interest at the rate of 10 percent per annum. Petitioner also derives financial support from tuitions, dues, and donations.

Petitioner's income statement for its first year of existence reflects the following:

TRIUNE OF LIFE CHURCH, INC.
STATEMENT OF INCOME
ELEVEN MONTHS ENDED MARCH 31, 1981

SALES - TABLES AND SUPPLIES		$4,904
COST OF GOODS SOLD		
Beginning inventory	$4,230	
Purchases	7,541	
Freight	266	
Goods available for sale	12,037	
Less: Ending inventory	8,122	
TOTAL COST OF GOODS SOLD		3,915
GROSS PROFIT		989
TUITION INCOME		71,268
TOTAL INCOME		72,257
OPERATING EXPENSES		
Advertising and publicity	$6,230	
Contributions	20	
Depreciation	5,674	
Dues and subscriptions	45	
Graduation expense	1,529	
Insurance	439	
Interest	3,703	
Office supplies and expense	2,058	
Postage	792	
Printing	6,737	
Professional fees	5,355	
Recruitment and travel	8,454	
Rent	14,850	
Repairs and maintenance	447	
Salaries	11,222	
Taxes and licenses	329	
Telephone	1,855	
Tutorium supplies and expense	692	
Miscellaneous expense	300	
TOTAL OPERATING EXPENSES		70,731
OPERATING INCOME		1,526
Interest Income		363
NET INCOME		1,889

Petitioner does not anticipate making any contributions to charities.

As of March 3, 1982, petitioner had achieved a degree of international recognition. At that time, there were more than 5,000 members—2,800 in the United States, 2,000 in Spain, and various undetermined numbers in Ireland, Mexico, and South Africa.

None of the officers of petitioner have received salaries, gifts, bonuses, or living expense reimbursements. Dr. Gold has devoted 40 to 80 hours per week to petitioner's activities and is not otherwise employed. Although Dr. Gold actually has received no salary thus far, he is accruing salary.

Sections 501(a) and 501(c)(3) provide an exemption from Federal income tax for organizations devoted to religious purposes if three prerequisites are satisfied: (1) The organization must be organized and operated exclusively for religious purposes or in conjunction with other exempt purposes; (2) no part of its net earnings may inure to the benefit of any private shareholder or individual; and (3) no substantial part of its activities may be devoted to political or lobbying activity.

Petitioner applied for recognition of tax-exempt status as a section 501(c)(3) religious organization. Respondent rendered an adverse determination with respect to said application on the grounds that: (1) Petitioner is not operated exclusively for a religious purpose; (2) petitioner is operated for the private interest of its incorporators or creators; and (3) part of petitioner's net earnings inures to the benefit of private individuals. It is only these grounds for denial of tax-exempt status that we must consider. *Houston Lawyer Referral Service v. Commissioner*, 69 T.C. 570, 573–574 (1978).

The burden of proof is on petitioner to overcome the grounds set forth in respondent's notice of determination. Rule 217(c)(2)(i); *Hancock Academy of Savannah, Inc. v. Commissioner*, 69 T.C. 488, 492 (1977). Moreover, the requirements for exemption under section 501(c)(3) are stated in the conjunctive, and failure to satisfy any one of them will prevent exemption. *Stevens Bros. Foundation, Inc. v. Commissioner*, 39 T.C. 93, 110 (1962), affd. in part and revd. in part 324 F.2d 633 (8th Cir. 1963), cert. denied 376 U.S. 969 (1964). Thus, to prevail herein, petitioner must prove not only that it is operated exclusively for religious purposes, but also that no part of its net earnings inures to the benefit of any private individual. We conclude that petitioner has failed to carry its burden of proof.

Section 1.501(c)(3)–1(c)(1), Income Tax Regs., elaborates on the requirement that the organization be operated exclusively for exempt purposes by providing as follows:

> (c) *Operational test*—(1) *Primary activities*: An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

If the nonexempt activities of an organization are more than incidental or insubstantial, the organization is not entitled to exemption, regardless of the number or importance of its exempt purposes. *Better Business Bureau v. United States*, 326 U.S. 279 (1945); *Copyright Clearance Center v. Commissioner*, 79 T.C. 793, 804 (1982).

It is not the nature of an organization's activities, but rather the purpose towards which they are directed that is ultimately dispositive of the organization's right to be classified as a section 501(c)(3) organization exempt from tax under section 501(a). The fact that an organization's activities constitute a trade or business does not, of itself, disqualify the organization under section 501(c)(3), provided the activities serve an exempt purpose.

Respondent asserts that petitioner has failed to supply sufficient information to establish that it meets the operational test. He contends that the information supplied indicates that petitioner may be operated for a substantial nonexempt purpose such as training and practicing an art similar to the art of chiropractic through which the private interests of the members of petitioner are served. Respondent notes that although petitioner claims that the practice of spinology differs from the practice of chiropractic, there is a basic similarity in that in both instances spinal manipulation is performed for a fee.

We agree with respondent that petitioner has failed to supply sufficient information to justify a determination that it is operated exclusively for exempt purposes.

The information supplied indicates that petitioner was founded by Dr. Reginald Gold, a chiropractor and an educator in a chiropractic college. Petitioner and the Tutorium, which it owns and operates, are operated from the same location. Petitioner holds services twice daily. The Tutorium holds classes twice daily. The only sacrament currently being administered by petitioner is spinology, which involves the gentle laying of the hands on a person by a certified spinologist. To become a spinologist in petitioner's organization, one must successfully complete the training course given by the Philadelphia Spinal Tutorium and agree to live by the doctrine of the organization. Tuition for the training course is $3,000 per year per student. Each spinologist conducts services with his or her own congregants at least once per month. Recipients of the sacrament of spinology are required to pay dues of an undisclosed amount to the spinologist administering the sacrament. A component of a spinologist's agreement to live by petitioner's doctrine is an agreement to pay a "tithe" to petitioner. The amount of the tithe required to be paid was not disclosed by petitioner, but there is some suggestion in the record that the amount of tithes is based on the amount of dues collected from the administration of the sacrament.[3]

Based on a review of the administrative record, we find that we are unable to disagree with respondent's assertion that a very substantial purpose of petitioner appears to be the training and practicing of an art akin to chiropractic. We note, in this connection, that one of the pamphlets contained in the administrative file is entitled, "Dare With Us Care With Us Share With Us explore an exciting new career opportunity as a Certified Spinologist." Pursuit of a professional practice or career is not one of the exempt purposes listed in section 501(c)(3).[4]

What we gather from the administrative record is that petitioner's organization, for a fee of $3,000, in substance, offers a training course which, when successfully completed, permits the graduate to practice the sacrament of spinology, an art that bears a striking resemblance to chiropractic. Recipients of the sacrament are required to compensate those who administer the sacrament, and the latter, in turn, are required to pay tithes to petitioner. Respondent contends that the overall arrangement indicates that petitioner is operated for the private benefit of its members, since the spinologists are compensated for rendering services akin to those rendered by chiropractors. In our view, respondent reasonably so inferred from the information submitted by petitioner. In addition, based on the administrative record before us, we believe petitioner had a disqualifying nonexempt purpose that is substantial in nature of operating a commercial business to produce net profits for petitioner in the form of tuitions and "tithes."

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[3] Since spinologists are exempt from tithing during their first year of practice, petitioner's income statement for its first year of existence does not show an entry for tithes.

[4] See *Labrenz Foundation, Inc. v. Commissioner*, T.C. Memo. 1974–296 (involving a foundation that provided chiropractic services).

Moreover, we are not satisfied that no part of the net earnings of petitioner inures to the benefit of any private individual within the meaning of section 501(c)(3).

The inurement prohibition under section 501(c)(3) denies exempt status to an organization whose founders or controlling members have a personal stake in that organization's receipts. *Church of Scientology of California v. Commissioner*, 83 T.C. 381, 491 (1984), on appeal (9th Cir., June 3, 1985). The basic thrust of the concept of private inurement is to ensure that an exempt charitable organization is serving a public and not a private interest. *Church of Scientology of California v. Commissioner, supra* at 491. Net earnings may inure to an individual in any of a number of ways other than by actual distribution of dividends. *Unitary Mission Church v. Commissioner*, 74 T.C. 507, 512–513 (1980), affd. without published opinion 647 F.2d 163 (2d Cir. 1981); *Founding Church of Scientology v. United States*, 188 Ct. Cl. 490, 497, 412 F.2d 1197, 1200 (1969), cert. denied 397 U.S. 1009 (1970). That the benefit conveyed may be relatively small does not change the basic fact of inurement. *Founding Church of Scientology v. United States*, 412 F.2d at 1200.

Petitioner admits that the income statement submitted and made a part of the administrative record reflects the operations of only the first year of petitioner's existence and does not represent anticipated income, including tithes and dues. In addition, because petitioner does not intend to make any donations to charity, it is unclear for whose benefit the funds received will be expended.

Petitioner's income statement indicates that $6,230 was expended on advertising. However, when respondent requested petitioner to provide copies of bulletins, announcements, or other documentation that services were being held, petitioner responded that "The Church feels that bulletins advertising services would be inappropriate and does not utilize them." Petitioner also stated that the $6,230 expenditure for "advertising" represented sums "used to recruit new trainees, to proselytize and to spread the doctrine of the Church."

In addition to the $6,230 that petitioner claims was spent for recruitment, petitioner's income statement shows that $8,454 was spent for "recruitment and travel." Petitioner claims that this latter expense was incurred as a result of the evangelical responsibilities of Dr. Gold in conducting lecture tours in France, Spain, and Africa. Petitioner submitted absolutely no documentation whatsoever with respect to these trips.

Petitioner's income statement also shows an entry for salary expense in the amount of $11,222. The administrative record is unclear with respect to the identity of the employees to whom the salaries were paid. Petitioner claims that Dr. Gold has received no salary thus far but that "he is accruing same and hopes the Church will be able to afford to pay him for his services some time in the near future." Petitioner's income statement, however, contains no entry for accrued salaries and petitioner has submitted no information with respect to how much salary Dr. Gold has accrued or will collect in the future.

The administrative record is simply too sketchy to support the conclusion that petitioner has carried its burden of proving that no part of its net earnings inures to the benefit of any private individual.

Since petitioner has failed to prove that it meets all of the requirements of section 501(c)(3), we hold that it does not qualify for tax-exempt status.

An appropriate order will be entered.

PETER J. LIO AND CATHERINE A. LIO, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DAVID H. ORTH AND BARBARA A. ORTH, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 29514–81, 13143–82. Filed July 24, 1985.

Ps each purchased a substantial number of unframed lithographs. After holding them for the period required for long-term capital gain treatment, Ps donated substantially all the lithographs to charitable organizations. *Held*, Ps were the ultimate consumers of the lithographs, and the market in which they purchased the lithographs is the appropriate market in which to value them for purposes of the charitable contribution deduction.

Paul C. Arshonsky, *Michael A. Sandberg*, and *Steven S. Brown*, for the petitioners.
Judy Jacobs, for the respondent.

SIMPSON, *Judge*: The Commissioner determined the following deficiencies in, and additions to, the petitioners' Federal income taxes:

Petitioners	*Taxable year*	*Deficiency*	*Addition to tax sec. 6653(a), I.R.C. 1954*[1]
Peter J. and Catherine A. Lio	1977	$19,732	$987
David H. and Barbara A. Orth	1979	16,389	- - -

After concessions, the issues presented for our consideration are: (1) Whether the determination of the fair market value of lithographs which the petitioners purchased in large quantities and donated to charities is to be based on the marketplace in which the petitioners purchased such lithographs, and (2) whether the petitioners were dealers in lithographs so that their charitable contribution deduction is limited to cost by section 170(e)(1)(A).

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

The petitioners Peter J. and Catherine A. Lio are husband and wife, who resided in Highland Park, Ill., at the time of the filing of the petition herein. They filed their joint Federal income tax return for 1977 with the Internal Revenue Service Center, Kansas City, Missouri. Petitioners David H. Orth and Barbara A. Orth are husband and wife, who resided in Olympia Fields, Illinois, at the time of filing their petition herein. They filed their joint Federal income tax return for 1979 with the Internal Revenue Service.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect during the years in issue.

A lithograph is a piece of paper which contains an artistically reproduced image. The image is produced by pressing the paper onto a hard object known as a plate, which has part of its surface covered with ink. Typically, a plate is used to create multiple impressions of the same image. Editions are usually limited in number. After the edition has been completed, the plate is then destroyed or canceled.

Lithographs are usually sold to the public by art galleries and art dealers. Galleries and dealers sell both framed and unframed lithographs to the public. While more lithographs are sold framed, it is not uncommon for the public to purchase unframed lithographs from galleries and dealers. The parties have agreed that such general statements are applicable to the Leonardo Nierman lithographs at issue in this case but did not agree that such general statements are applicable to the William Nelson lithographs at issue in this case.

A frame provides a visual border for a lithograph but does not otherwise physically affect it. The process of framing or removing a lithograph from a frame does not physically affect the lithograph. Lithographs, if displayed, are typically framed. A framed lithograph is sold for an average of $75 more than the lithograph unframed, but this increment may vary depending upon the quality and size of the frame.

On January 28, 1977, Dr. Lio entered into a contract to purchase 150 unframed lithographs by the artist William Nelson from Art Appraisers of America, Ltd. (AAA), for $7,500 ($50 each).[2] Dr. Lio made the required payment for the lithographs, and they were delivered to him.

AAA was the sole publisher and distributor of William Nelson lithographs during 1976, 1977, and 1978. The "Standard Purchase Agreement" (the agreement) entered into between Dr. Lio and AAA states that Mr. Nelson is in the process of creating 30 or more original lithographs, each in a limited and numbered edition of not more than 500, plus 20 artist's proofs, which AAA will divide into approximately 75 investment portfolios containing 200 assorted lithographs each. The particular lithographs purchased by Dr. Lio were not specified in the agreement.

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[2] The agreement actually states that Dr. Lio (the "collector") agrees to purchase one investment portfolio containing 200 assorted lithographs for $10,000, but it is clear from the stipulations and other exhibits that only 150 lithographs were sold to him for a total purchase price of $7,500.

The agreement also provides that at the time of delivery, AAA will supply Dr. Lio with two "independent appraisals" stating that the fair market value of each lithograph contained therein is not less than $150. The agreement further states that within 1 year after the investment portfolios are delivered to Dr. Lio, AAA shall, upon request, supply at no additional charge a list of charitable organizations which will accept a donation of the lithographs and two independent appraisals setting forth their then current fair market value.

On November 29, 1977, Dr. and Mrs. Lio, having owned the lithographs for more than 9 months,[3] donated the following 150 William Nelson unframed lithographs to the Rockford Art Association/Burpee Art Museum (Rockford Museum)[4] in Rockford, Illinois:

Title	*Quantity purchased*	*Numbers of lithographs donated*	*Number in edition*
The Mailbox	25	106,107, 163–185	[5]300 plus 20 AP
Baton Pass	25	1 - 25	500 plus 20 AP
Ready to Haul	25	91 - 115	500 plus 20 AP
Prairie View Feed Co.	25	31 - 55	350 plus 20 AP
Flying Jibs	25	92 - 116	350 plus 20 AP
Kedzie L	25	248 - 272	350 plus 20 AP

In 1977, two other individuals each donated 200 William Nelson lithographs to the Rockford Museum. The museum has not accessioned the Nelson lithographs to its permanent collection or displayed them, nor does it have a present intention to do so. The museum did not insure the lithographs. Dr. Lio insured the lithographs for a total of $1,000 when he mailed them to the museum.

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[3] The required holding period for long-term capital gain treatment was 9 months for taxable years beginning in 1977. See secs. 1222(3) and 170(e)(1)(A).

[4] The Rockford Museum is an organization described in sec. 170(c).

[5] Artist's proofs.

Membership in the Rockford Museum costs $15 for an individual and $25 for a family. In 1981, five of the Nelson lithographs were given away by the Rockford Museum as part of a promotional incentive to individuals and families to become new members. The remaining 545 Nelson lithographs donated in 1977 are in storage on the museum's premises.

During 1977, AAA sold 12,225 Nelson lithographs, 97 percent of which were sold for $50 or less. Ninety-eight percent of the 12,225 lithographs were sold to individuals predominantly in quantities of from 50 to 400 lithographs. None of the lithographs from the five Nelson editions purchased by Dr. Lio was sold for more than $50. Ninety-six percent of all sales of Nelson lithographs during 1977 were for $50.

From 1975 through 1980, Nelson lithographs were also marketed by mail order. Jean Paul Loup, a mail order dealer, sold 580 Nelson lithographs comparable in size, method of reproduction, quality of printing, thematic character, and quantity of edition to those donated by Dr. Lio. Approximately 75 percent of the 580 lithographs were sold for $150 each.[6] Of this number, 114 lithographs were sold in multiples of from 2 – 11 to 38 purchasers. The relatively few lithographs which sold for more than $150 (generally from $200 to $300 each) were from different editions than those that sold for $150 or less. The remainder of the lithographs were sold to dealers individually, usually at a 50-percent discount from the price charged nondealers.

In December 1979, Merrill Chase Galleries (Merrill Chase), a chain of art galleries in the Chicago area, acquired 52 unframed Nelson lithographs comparable in size, method of reproduction, quality of printing, thematic character, and quantity of edition to those donated by the petitioner. By February 28, 1980, the chain had sold 37 of the lithographs, framed, for $260 to $325 each. Merrill Chase subsequently acquired additional Nelson lithographs and sold a total of 68 from December 1979 to the date of trial. There were no sales of Nelson lithographs by Merrill Chase prior to December 1979.

Dr. Lio is a dentist, and Mrs. Lio devotes her time to raising the couple's three children. They did not at any time advertise, promote, or display lithographs for sale to third parties. No books of account relative to lithographs were maintained by the Lios, nor did they maintain a separate office or store for the purchase, maintenance, or subsequent contribution of lithographs. They did not have any business stationery, nor did they maintain a separate mailing address or telephone number for their purchase or donation of lithographs.

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[6] Jean Paul Loup also sold watercolor paintings by William Nelson. Five such sales were consummated with prices ranging from $500 to $2,700.

On their 1977 Federal income tax return, Dr. and Mrs. Lio claimed a charitable contribution deduction of $24,688 for the donation of the 150 Nelson lithographs to the Rockford Museum. On November 14, 1977, Bruce Duncan, president of the Chicago Appraisers Association, valued the 150 lithographs at $26,875, and on November 15, 1977, Bruce B. Kodner, an appraiser for Howard Art Galleries, Inc., Chicago, Ill., appraised the 150 lithographs at $150 each for a total value of $22,500. The contribution deduction claimed by the Lios is an average of the appraisals received from Mr. Duncan and Mr. Kodner. These appraisals were prepared in accordance with the provisions of Dr. Lio's contract with AAA.

In the notice of deficiency, the Commissioner disallowed the deduction to the extent it exceeded $7,500, Dr. and Mrs. Lio's cost basis in the lithographs. The Commissioner conceded that there is no addition to tax for negligence due from the Lios and that they are entitled to an ordinary loss in 1977 of $5,300 from Randolph Research Associates.

On September 15, 1978, Dr. and Mrs. Orth purchased the following 100 unframed Nierman lithographs from Greenwich Art Consultants, Inc. (Greenwich), for $10,000:

(a) One single suite entitled "Intuition de L'Univers" Suite #123
(b) Three double suites entitled "Intuition de L'Univers" Suites #XV/LXXV, XVIII/LXXV, and XLV/LXXV
(c) One suite entitled "Sound of Color" Suite #XVI/LXXX
(d) Four Mahler lithographs #151, 152, 153, and 154/250
(e) One Brahms lithograph #176/250
(f) Four Debussy lithographs #149, 150, 151, and 152/250
(g) Four Bach lithographs #150, 151, 152, and 153/250
(h) Four Mozart lithographs #156, 157, 158, and 159/250
(i) Two Ravel lithographs #138 and 139/250
(j) Four Stravinsky lithographs #197, 198, 199, and 200/250

On March 30, 1979, Dr. Orth insured the lithographs with Safeco Insurance Co. of America, ascribing a value of $300 to each lithograph.

A "suite" is a term used in the retail art industry for a set of works by the same artist (or sometimes by different artists) often on the same theme or subject matter that are compiled and offered together as a set. A single suite of "Intuition de L'Univers" consists of 10 lithographs, and a double suite of "Intuition de L'Univers" contains 20 lithographs. There are 271 "Intuition de L'Univers" suites in existence, consisting of 101 double suites and 170 single suites. Thus, there are 3,720 individual lithographs from such suite in existence.

Each "Sound of Color" suite contains seven lithographs. There are 350 "Sound of Color" suites in existence. Thus, there are 2,450 individual lithographs from such suite in existence.

In December 1979, Dr. Orth, having owned the Nierman lithographs for more than 12 months[7] after purchase, donated 73 lithographs, unframed, to the following organizations, all of which qualify under section 170(c):

Organization	*Lithographs*	
Mundelein High School	One suite"Sound of Color" suite #XVI/LXXX (7 lithographs)	
Waukegan Public Schools	1. Mozart	157/250
	2. Debussy	151/250
	3. Mahler	154/250
	4. Bach	150/250
	5. Stravinsky	197/250
Thornton Fractional High School	One double suite "Intuition de L'Univers" suite #XVIII/LXXV (20 lithographs)	
Chicago Public Library	1. Mozart	158/250
	2. Debussy	150/250
	3. Mahler	153/250
	4. Bach	152/250
	5. Stravinsky	198/250
Chicago Board of Education	1. Mozart	156/250
	2. Debussy	149/250
	3. Bach	151/250
	4. Mahler	151/250
	5. Ravel	138/250
	6. Stravinsky	199/250

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[7] For the taxable year 1979, the holding period required for long-term capital gain treatment was 12 months. See secs. 1222(3) and 170(e)(1)(A).

Organization	*Lithographs*
The Woodlawn Organization	One single suite "Intuition de L'Univers" suite #123/150 (10 lithographs)
Deerfield Public Schools	One double suite "Intuition de L'Univers" suite #XV/LXXV (20 lithographs)

Lublin Graphics, Inc. (Lublin), was the sole U.S. distributor of Nierman lithographs. Lublin also published and distributed works by other artists. Prior to 1983, virtually all of the lithographs sold by Lublin were unframed sales to art dealers and art galleries for resale to the public. In 1975, Lublin began selling lithographs from the "Intuition de L'Univers" edition. None of the 3,720 lithographs originally printed remained in inventory at Lublin at the time of trial. In 1976, Lublin began selling lithographs from the "Sound of Color" edition. As of the date of trial, approximately 200 of the 2,450 lithographs originally printed remained in inventory at Lublin.

Art Consultants Ltd. (Art Consultants) was a subchapter S corporation incorporated in 1977. It was also called Sinclair Galleries, Ltd. Its business consisted of selling graphics, which are multiple artistic reproductions and include the subcategory of lithographs. Virtually all of the graphics sold by Art Consultants were unframed, and virtually all of the sales were to individuals.

Art Consultants did not have a public area for the display of art. Most of the art sold by it was "drop shipped," which means that it was shipped directly from the publisher or distributor to the individual who purchased it from Art Consultants. Art Consultants used an office which was rented by the law firm of Kamensky & Landan (now Kamensky & Rubinstein) and which was within the suite occupied by the law firm. This office was used to store art and to maintain the books and records of Art Consultants.

Greenwich was a joint venture between Art Consultants and Preferred Partnerships, Inc. Greenwich was formed for the limited purpose of selling lithographs from the "Sound of Color" and the "Intuition de L'Univers" editions. It used the facilities and personnel of Art Consultants. Greenwich sold the Nierman lithographs unframed to individuals for $100 each. It did not sell any art to galleries.

During 1978 and 1979, Lublin sold a total of 2,319 Nierman lithographs. During 1978 and 1979, Greenwich purchased approximately 63 percent (1,473) of the Nierman lithographs sold by Lublin for $50 each. All of the Nierman lithographs purchased by Greenwich during 1978 and 1979 were from either the "Sound of Color" or the "Intuition de L'Univers" suites, and such purchases constituted approximately 24 percent of the total lithographs in existence from each suite.

Greenwich sold almost all of its Nierman lithographs that it purchased from Lublin. The sales were all for $100 per lithograph and took place in 1978 and January of 1979. Virtually all of the lithographs were sold in large quantities to individuals.

In 1979, galleries sold an unspecified number of single lithographs from the "Sound of Color" and the "Intuition de L'Univers" editions for approximately $300, unframed. Lithographs from the "Sound of Color" edition are still available for sale in some galleries.

There are no markets, and in 1979 there were no markets, for Nierman lithographs other than the markets herein described.

Dr. Orth framed 9 of the 100 Nierman lithographs purchased from Greenwich in 1978. Those 9 lithographs have been on display since 1980 in Dr. Orth's office. The remaining 18 lithographs are in storage.

On February 25, 1980, Art Consultants sent Dr. Orth the following items to be used in preparing his 1979 Federal income tax return: (1) Letters from the organizations to which he contributed the lithographs acknowledging their receipt; (2) two appraisals of the 73 lithographs—one by R. Bruce Duncan, president of the Chicago Appraisers Association, who appraised them at $24,000, and one by Ross Edman, an appraiser of arts and antiques in Chicago, Ill., who appraised them at $24,464; and (3) photographs of the lithographs.

Dr. Orth is a physician. Dr. and Mrs. Orth did not at any time advertise, promote, or display lithographs for sale to third parties. They did not sell any lithographs. No books of account relative to lithographs were maintained by the Orths, nor did they maintain a separate office or store for the purchase, maintenance, and subsequent contribution of lithographs. The Orths did not have any business stationery, nor did they maintain a separate mailing address or telephone number, for their purchase or donation of lithographs. Dr. Orth devoted substantially all of his working time to his occupation as a physician.

On their Federal income tax return for calendar year 1979, Dr. and Mrs. Orth claimed a charitable contribution deduction of $27,682 (or approximately $379 each) for the donation of 73 Nierman lithographs to qualified charitable organizations. It is not apparent from the record how the Orths arrived at that figure, but on brief, they argue that the lithographs had a total fair market value of $21,900 (or $300 each) as of the date of donation.

In the notice of deficiency, the Commissioner disallowed the Orths' claimed deduction to the extent it exceeded $7,300, the cost of the lithographs. For purposes of this trial, we have severed the issue concerning the amount of the allowable deductions for the contribution of the lithographs, and our opinion will deal only with that issue.

OPINION

The primary issue for our decision in this case is whether the fair market value of lithographs donated to charitable organizations exceeds the amounts paid by the petitioners for such lithographs. If we find that there is such an excess, we must then decide whether the petitioners' charitable contribution deductions are nevertheless limited to cost by section 170(e)(1)(A).[8]

Section 170(a)(1) allows a deduction for any charitable contribution to or for the use of an organization described in section 170(c), payment of which is made during the taxable year. In general, the amount of a charitable contribution made in property other than money is the fair market value of the property at the time of the contribution. Sec. 1.170A-1(c)(1), Income Tax Regs. Section 1.170A-1(c)(2) of the regulations defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts." See *United States v. Cartwright*, 411 U.S. 546 (1973); *McShain v. Commissioner*, 71 T.C. 998, 1004 (1979). Fair market value is a question of fact to be determined from an examination of the entire record. *Skripak v. Commissioner*, 84 T.C. 285, 320 (1985); *Zmuda v. Commissioner*, 79 T.C. 714, 726 (1982), affd. 731 F.2d 1417 (9th Cir. 1984); *Jarre v. Commissioner*, 64 T.C. 183, 188 (1975). The petitioners bear the burden of proving that the Commissioner's determination of the fair market value of the property involved herein is in error. Rule 142(a), Tax Court Rules of Practice and Procedure; *Welch v. Helvering*, 290 U.S. 111 (1933).

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[8] Because the Lios and the Orths received letters from the charities to which they donated the lithographs stating that they would be used in a manner relating to the purpose or function constituting the basis for the charities' exemption under sec. 501, the Commissioner concedes that sec. 170(e)(1)(B) does not limit the amount of the petitioners' contribution deduction. See sec. 1.170A-4(b)(3)(ii)(*b*), Income Tax Regs.

Although section 170 and the regulations promulgated thereunder are silent as to the market to be used in determining the value of donated property, it has been recognized that the valuation test for estate and gift tax purposes is generally the same as that used for charitable contribution deduction purposes. *United States v. Parker*, 376 F.2d 402, 408 (5th Cir. 1967); *Anselmo v. Commissioner*, 80 T.C. 872, 881–884 (1983), affd. 757 F.2d 1208 (11th Cir. 1985). Section 20.2031–1(b), Estate Tax Regs., and section 25.2512–1, Gift Tax Regs., provide that the fair market value of an item of property is to be determined in the market where such item is "most commonly sold to the public." Sec. 20.2031–1(b), Estate Tax Regs., provides in relevant part as follows:

> Thus, in the case of an item of property * * * which is generally obtained by the public in the retail market, the fair market value of such an item of property is the price at which the item or a comparable item would be sold at retail. For example, the fair market value of an automobile (an article generally obtained by the public in the retail market) * * * is the price for which an automobile of the same or approximately the same description, make, model, age, condition, etc., could be purchased by a member of the general public and not the price for which the particular automobile * * * would be purchased by a dealer in used automobiles. * * * All relevant facts and elements of value as of the applicable valuation date shall be considered in every case. * * *

In the *normal* situation, a sale "to the public" refers to a sale to the "retail customer who is the ultimate consumer of the property." *Anselmo v. Commissioner*, 80 T.C. at 882; see also *Skripak v. Commissioner*, *supra* at 322. The determination of the proper market for valuation purposes is also a question of fact. *Anselmo v. Commissioner*, 757 F.2d at 1213.

In *Anselmo v. Commissioner, supra*, we were required to value a donation of 461 colored gemstones. We rejected the petitioners' contention that the valuation of the stones should be based on sales of jewelry containing such stones to ultimate consumers and that the value of the stones equaled the portion of such price attributable to the stone. We found that such stones were not commonly sold to individual purchasers but rather that they were sold to retail jewelers for use in the manufacture of jewelry. We said:

> The last stage in the chain of distribution at which unset gems like petitioner's are sold is the sale by wholesalers, jobbers, or memorandum houses to jewelry stores of individual stones or small parcels of stones. This is the nearest we have to a sale to the public. We have therefore found as a fact that jewelers, not individual purchasers, at retail, are the ultimate consumers of these stones. Thus, the sale of individual stones to the store is not, in our case, a sale for resale; it is a sale for consumption of the stone. It is this transaction which must be treated as a sale to the public. [80 T.C. at 882.]

In *Skripak v. Commissioner, supra*, we were asked to value scholarly reprint books. We found that, with respect to such books, the market in which they are ordinarily sold to the ultimate consumer is the "retail market place, comprised largely of institutional buyers (libraries) and, to a minor extent, of individuals seeking a specific scholarly text." 84 T.C. at 322. However, we rejected the evidence offered by the petitioners concerning the prices at which such books were sold at retail; in explanation, we said:

> the major flaw in petitioners' valuation approach * * * is petitioners' failure to consider the sheer numbers of books that are to be valued for each petitioner. As against this, the information relied upon by petitioners is simply insufficient to represent the large universe of reprint titles the Court is called upon to value. [84 T.C. at 324.]
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> * * * The simultaneous marketing of all those books would substantially depress the market for each particular reprint title and for the multiple copies of each title. * * * [84 T.C. at 325.]

In *Chiu v. Commissioner*, 84 T.C. 722 (1985), we were again required to value a gift of colored gemstones. Both the petitioners and the Commissioner presented expert opinions to support their views of the value of the stones. However, we found such expert testimony not to be convincing, and we concluded that the prices actually paid for the stones represented the most reliable evidence of their value. There was no evidence that the petitioners had purchased the stones "at prices not reflecting the appropriate market" or that the stones had appreciated in value between the times of the purchases and their gifts. *Chiu v. Commissioner, supra* at 736.

Under these cases,[9] we must first identify the market where the lithographs at issue in this case are commonly purchased by the ultimate consumers and ascertain the price paid for them in such market. *Anselmo v. Commissioner*, 80 T.C. at 882. The petitioners argue that lithographs are most commonly sold to the public by art galleries and dealers at retail prices and that, therefore, the prices charged by such galleries and dealers for individual Nelson and Nierman lithographs are determinative of fair market value. They maintain that since art galleries sold an unspecified number of unframed Nierman lithographs from the same editions as those at issue for $300 each in 1979, and since some similar Nelson lithographs were sold by a mail order dealer unframed at $150 each from 1975 through 1980 and by a gallery framed for $260 to $325 each between December 1979 and February 28, 1980, they are entitled to charitable contribution deductions of $300 for each of the donated Nierman lithographs and of $150 for each of the donated Nelson lithographs. We do not agree with the petitioners' definition of the appropriate market.

The petitioners did not testify as to their motives for purchasing the lithographs, but it is abundantly clear from the stipulations and exhibits in the record that they purchased the lithographs for their own use or for subsequent donation. Dr. Lio is a dentist, and Mrs. Lio devotes her time to raising their children. The Lios are not in the business of buying and selling lithographs. Similarly, Dr. Orth is a physician, and the Orths are not in the business of buying and selling lithographs. Furthermore, as a part of the arrangements for the purchase of the Nelson lithographs, AAA provided Dr. Lio with a list of museums that would accept such lithographs, and both AAA and Greenwich furnished appraisals to the Lios and Orths that could be used for tax purposes. In fact, Dr. and Mrs. Lio made a gift of the entire 150 lithographs purchased by them. Dr. and Mrs. Orth made a gift of 73 of the lithographs purchased by them, displayed 9 of them in Dr. Orth's office, and retained in storage the remaining 18. Under these circumstances, it is clear that the Lios and Orths did not purchase the lithographs for resale; they were ultimate consumers of the lithographs.

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[9] See also *Lightman v. Commissioner*, T. C. Memo. 1985-315; *Lampe v. Commissioner*, T. C. Memo. 1985-236; *Price v. Commissioner*, T. C. Memo. 1985-182; *Theodotou v. Commissioner*, T. C. Memo. 1985-181; *Talebi v. Commissioner*, T. C. Memo. 1985-180

Lithographs may be purchased by individuals from galleries or from those dealers that sell each lithograph separately, but such are not the only sources for purchasing lithographs. Indeed, the facts of this case demonstrate that most of the lithographs of the types at issue were not purchased from such sources. During 1976, 1977, and 1978, AAA was the sole distributor of the Nelson lithographs, and in 1977 (the Lios' taxable year in issue), it sold 12,225 of them. Ninety-eight percent of such sales were made to individuals in lots of 50 to 400 each. Likewise, in 1978 and 1979, Lublin, which was the sole American distributor of the Nierman lithographs, sold 63 percent (1,473) of such lithographs in those years to Greenwich, and Greenwich sold all of such lithographs in large quantities to individuals. Thus, the sales of these lithographs by galleries and small dealers constituted a miniscule part of the market; most of the sales were made by AAA and Greenwich. Moreover, most of the sales by the galleries and small dealers were of one or only a few lithographs at a time; whereas, Dr. Lio purchased 150, and Dr. Orth purchased 100, of the lithographs. Although the petitioners made bulk purchases of the lithographs in issue, there is no evidence that individual lithographs could not have been purchased for the same price from AAA and Greenwich. Hence, the sales by AAA and Greenwich must be taken into consideration when we seek to find the prices most commonly paid by the individuals who purchase these lithographs for their own use or for gifts to museums.

Clearly, on the facts before us, AAA and Greenwich acted as art dealers, and the petitioners purchased the lithographs as individual customers. The sales of the lithographs to the petitioners were as much sales to "ultimate consumers" as the sales by art galleries and dealers to other individuals upon which the petitioners rely. It is common knowledge that a consumer can pay a wide range of *retail* prices for the same item depending on where he chooses to shop and how much investigating he does of the various sources of a particular item. See W. Speiller, "The Favored Tax Treatment of Purchasers of Art," 80 Colum. L. Rev. 214, 228–229 (1980). We do not construe the term *retail* as used in this context to mean that where a consumer has a choice of several sources for an item, only the most expensive source is a retail sale and all other sources are wholesale. Rather, the sale to the ultimate consumer is any sale to those persons who do not hold the item for subsequent resale (see *Goldman v. Commissioner*, 388 F.2d 476, 478 (6th Cir. 1967), affg. 46 T.C. 136 (1966)), and the most appropriate market for valuation purposes is the most active marketplace for the particular item involved. In the present case, the most active marketplace for Nelson and Nierman lithographs was the marketplace in which the petitioners purchased them.

A few individuals paid as much as $300 for each of the Nierman lithographs and $150 each for similar Nelson lithographs, but such prices clearly do not reflect the prices commonly paid for such lithographs. See *Skripak v. Commissioner*, 84 T.C. at 323–324. In the case of the Nierman lithographs, the only evidence of sales of such lithographs, other than those by Greenwich, is the stipulation that, in 1979, art galleries sold single lithographs of the type at issue for $300. There was no evidence of the number of such sales, the types of customers, or other relevant information; whereas, we know that, in 1978 and 1979, Greenwich sold approximately 63 percent (1,473) of such lithographs at a price of $100 each. Such evidence of value is far more persuasive than the vague stipulation. See *Chiu v. Commissioner, supra*.

In the case of the Nelson lithographs, the petitioners rely on the sales by Jean Paul Loup and by Merrill Chase. The mail order sales by Jean Paul Loup were made over the years 1975 to 1980 and consisted of 580 lithographs, of which approximately 75 percent were sold for a price of $150 each. The sales by Merrill Chase consisted of only 37 sales made in late 1979 and early 1980 at a price of from $260 to $325 for each lithograph, framed. On the other hand, in 1977, AAA sold 12,225 Nelson lithographs, and 97 percent of such sales were made at a price of $50 or less for each lithograph. Again, the sales by AAA constitute far more persuasive evidence of the value of the lithographs than the relatively few sales made by Jean Paul Loup or Merrill Chase. *Chiu v. Commissioner, supra*. Furthermore, the Rockford Museum has not insured, accessioned to its permanent collection, or displayed the Nelson lithographs. The use to which donated property is put is relevant in determining fair market value. *Chiu v. Commissioner*, 84 T.C. at 736; *Skripak v. Commissioner*, 84 T.C. at 322.

The evidence of fair market value in this case resembles the situation in *Chiu v. Commissioner, supra*. In that case, the parties sought to rely on expert opinions of fair market value, but the Court found such testimony to be unpersuasive. The Court concluded that the prices actually paid presented far more convincing evidence of value. *Chiu v. Commissioner*, 84 T.C. at 734. In *Skripak v. Commissioner, supra*, the petitioners relied on an expert opinion that was based on only a relatively few sales, and the Court rejected such evidence because it failed to take into consideration the bulk of the sales. 84 T.C. at 324. Similarly, in this case, the petitioners seek to establish fair market value by relying on the prices paid in only a few sales. We find much more persuasive the actual prices paid by the petitioners only a short period of time prior to the valuation dates and the evidence of the prices paid by others who purchased from the same sources as the petitioners. Furthermore, there is no evidence that the petitioners received any special discount not generally available to others who purchased under similar circumstances or that there was any significant appreciation in the value of the lithographs between the times of the purchases and the gifts. See *Tripp v. Commissioner*, 337 F.2d 432, 434–435 (7th Cir. 1964), affg. a Memorandum Opinion of this Court. Accordingly, we hold that the fair market value of the Nierman lithographs at the time of their donation was $100 each and that the fair market value of the Nelson lithographs at the time of their donation was $50 each. In view of this conclusion, we do not reach the Commissioner's alternative argument.

Decision will be entered under Rule 155 in docket No. 29514–81.

An appropriate order will be issued in docket No. 13143–82.

JOSEPH F. MOORE, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 16743–83. Filed July 25, 1985.

T purchased at a purported price of $384,000 a tax shelter from U.S. Distributor structured as an exclusive territorial franchise or distributorship to sell gemstones and items of jewelry to be supplied by American Gold. T was one of about 1,000 purchasers of similar exclusive territorial franchises from U.S. Distributor. The minimum price for such an exclusive territorial franchise was purportedly $240,000. American Gold and U.S. Distributor were corporations newly created by tax shelter promoters, and had no goodwill. American Gold transferred to U.S. Distributor the exclusive right to distribute American Gold's "product" worldwide. U.S. Distributor paid nothing for this right, but proceeded to fragment it into exclusive territorial distributorships which it then undertook to market. American Gold's "product" was to be obtained from Davis, an individual who was actively engaged in the gemstone and jewelry business, but who was under no binding obligation to make any product available to American Gold. The principal purpose of the tax shelter was to take advantage of sec. 1253 of the Internal Revenue Code. *Held*: On this record, the purported exclusive territorial franchise acquired by T was a sham, and he is not entitled to any deductions as "distributor's fees" under sec. 1253(d)(2)(B)(ii) or otherwise in respect of annual installments purportedly paid by him for his distributorship. He never made any sales nor attempted to make any sales or even explored the possibility of making any sales in his alleged exclusive territory. *Held, further*: The mere fact that T engaged in some profit-oriented jewelry transactions, either individually or as part of joint venture, primarily through a subsidiary of American Gold did not impart bona fides to his exclusive territorial franchise. None of those transactions occurred in or had any relationship to his "exclusive territory," and were entered into in part as part of an effort to create the illusion of bona fides of the exclusive territorial franchise. Since they were nevertheless profit-oriented, petitioner is entitled to deduct, under sec. 212 or possibly sec. 162, the ordinary and necessary expenses incurred in respect of such transactions. Such deductible expenses do not include his spurious exclusive "territorial distributorship fees."

Philip R. Linsley, Joseph F. Moore, pro se, and *John E. Crooks*, for the petitioner.

John O. Kent and *Gregory A. Roth*, for the respondent.

RAUM, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income taxes for 1979 and 1980 in the amounts of $11,845 and $7,618, respectively. The principal substantive issue for decision is whether the Commissioner erred in disallowing losses with respect to petitioner's purported activity as an "exclusive territorial distributor" of gemstones.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated herein by reference.

Petitioner was a resident of Glendale, California, when he filed his petition herein.

Petitioner is an attorney, licensed to practice law in the State of California. He is experienced in Federal tax law. He has appeared as counsel in this Court in tax shelter litigation, and he has qualified and testified as an expert witness in at least one criminal tax matter involving a tax shelter promoter.

The losses in issue herein arose out of petitioner's involvement in a tax shelter based upon a gemstone distributorship program (program) organized by Joseph R. Laird (Laird) and John Crooks (Crooks). Laird and Crooks are California attorneys who have organized and promoted tax shelters. Laird, the "mastermind" of the gemstone program herein, has promoted shelters involving real estate, coal, master recordings, motion pictures, and gemstones. He is cited as the "promoter" in *Beck v. Commissioner*, 74 T.C. 1534, 1536, (1980), affd. 678 F. 2d 818 (9th Cir. 1982). See also *Oneal v. Commissioner*, 84 TC. 1235, 1242 n. 10 (1985). Petitioner worked an an "associate" in Laird's law firm from the summer of 1976 until around September 1979, when he became associated with the law firm which "represented" Laird. Crooks is petitioner's "friend * * * and an associate * * * in certain matters," and is one of the attorneys of record in this case.

Another person who played a prominent part in the organization and operation of the gemstone tax shelter herein is Frank Davis (Davis), a resident of Utah. He was in the jewelry business and was experienced in or familiar with the mining, cutting, importing, purchasing, selling, and mounting of diamonds and other precious gems. Davis became interested in the jewelry business sometime in the late 1960's, and, in 1969, he was employed in a "supervisory capacity" in a Brazilian diamond mining operation. Upon returning from Brazil, he enrolled in courses offered by the Gemological Institute of America, and earned a certificate in diamond grading and evaluation. Sometime during the mid-1970's he was engaged as a "manager" for Kimberly Distributors, a wholesale, manufacturing diamond distributorship, where a person named Larry Rutherford (Rutherford) worked for him as a salesman.

Sometime in 1976 or 1977, Davis and Rutherford decided to leave Kimberly Distributors and start their own diamond wholesale operation. Thereafter, Davis, his wife, and Rutherford incorporated DWR, INC., (DWR) to engage mainly in the wholesaling of diamonds to the jewelry trade. Originally, Davis and his wife owned all of the stock of DWR, but Rutherford eventually exercised an option and became a minority shareholder of the company.

DWR's business flourished. Initially, it sold its products to "jewelry stores, * * * wholesalers and dealers." Then, in 1977 or 1978, as the demand for investment grade diamonds, the highest quality diamonds, expanded, DWR started to sell to firms which were interested in diamonds mainly as an investment, rather than simply as jewelry. Davis estimated that by early 1979, DWR's gross sales had reached "a couple of million dollars" and that he, and thus DWR, had "access" to over $10 million worth of gemstones, primarily from the inventory of other suppliers, principally in New York, including some of the suppliers who enjoyed the privilege of buying diamonds directly from the DeBeers diamond cartel ("sight" buyers).

DWR was well-positioned to take advantage of the growing demand for investment grade diamonds. Although Davis resided in Utah and carried on DWR's business from a base in that State, he had private line connections with important sources in New York. He had well developed "loyalties" within the trade, and, because he was interested in buying for DWR all types of diamonds, not just the investment grade type, he had a favorable position with suppliers who were then besieged with investors searching for only high quality diamonds.

Rutherford's work for DWR was largely that of a salesman. In June 1979, he attended the first annual Precious Gems

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International Conference, a conference for those "interested in tangible assets as a medium of investment." There he met Laird and Crooks, who presented him with "a concept and a business approach * * * [for] creating [a] market for distributing diamonds and gemstones." This "concept and * * * approach" basically involved DWR's selling the right to distribute its product to "people interested in the diamond and precious stone world" who would then sell the product on a consignment basis through retail jewelry stores.

Rutherford reported Laird's and Crooks' distributorship proposal to Davis, who thereafter met with Laird and Crooks to discuss the idea more fully, and who found the proposal acceptable.

Soon after Laird, Crooks, Davis, and Rutherford discussed the distributorship proposal, they formed three entities: American Gold & Diamond Corp. (American Gold), United States Distributor, Inc. (U.S. Distributor), and Gem-Mart Consultants, Inc. (Gem-Mart). American Gold, a Utah corporation, initially owned equally by Davis and Rutherford, was to supply gemstones to the program at a price which would purportedly allow the distributors to earn a profit on the product's resale. Like DWR, American Gold was to be an entity through which Davis could buy and sell gemstones. DWR was not availed of to supply products to the program since Davis was yet unwilling to "blend" DWR's reputation with the program. Davis had no legal obligation to supply gemstones to American Gold or to distribute them through it.

U.S. Distributor, a Nevada corporation, initially owned by Crooks and Laird, was to market the distributorship program. American Gold granted it the exclusive "right" to distribute American Gold's "product" worldwide for a period of 50 years, beginning with July 1, 1979. U.S. Distributor paid American Gold nothing for this right. U.S. Distributor was then to sell the right to distribute American Gold's "product" within certain specific geographic areas defined by zip code ("distributorships") to investors ("territorial distributors") like petitioner, who, as will appear hereinafter, "purchased" one of the distributorships. The distributorships were marketed by U.S. Distributor through a team of salesmen experienced in financial matters but in general unfamiliar with precious gems or the jewelry business. In marketing the distributorships, emphasis was placed upon tax savings. The distributorships were sold to persons who were inexperienced in the jewelry business. The minimum price for a distributorship was $240,000, and increased substantially depending primarily upon the amount of tax savings sought by the purchaser. The price of the distributorship purchased by petitioner, hereinafter more fully described, was $384,000. The goal of the program was to sell about 5,000 distributorships, but ultimately only some 1,000 were sold.

Gem-Mart, a wholly owned subsidiary of American Gold, was to take advantage of Davis' sales ability and theoretically to assist the territorial distributors in selling the product to jewelry stores. It was to act as the "sales arm" for the territorial distributors.

Soon after the above-described entities were created, Laird and Crooks purchased Rutherford's interest in American Gold. Thereafter, Davis traded one-half of his interest in American Gold for a one-quarter interest in U.S. Distributor. Also, at some unspecified time, Crooks, or a member of his family, purchased Laird's interest in American Gold and U.S. Distributor. Upon the conclusion of these transfers, Davis emerged as the owner of one-fourth of the stock of American Gold and U.S. Distributor, and Crooks (together with his family) owned three-fourths of the stock of each of these corporations.

Sometime in late 1979, Crooks requested petitioner to examine a draft tax opinion letter concerning the tax shelter program involved herein and asked whether he would assist in the program's tax defense. After reviewing the letter, petitioner not only agreed to aid in the tax defense, but also decided to acquire a distributorship for himself.

The operative document reflecting the purchase and sale of a territorial distributorship is contained in a pamphlet captioned "Contract Documents." The pamphlet contains a "Tax Opinion Letter," the "Territorial Distributorship Agreement," and "Exhibits." Each pamphlet bears a serial number, and U.S. Distributor is identified at the lower half of the front cover with an address in Carson City, Nevada. There were at least two copies of the pamphlet in respect of each purchase and sale, one containing the executed Territorial Distributorship Agreement retained by the purchaser, and the other containing the duplicate original executed Territorial Distributorship Agreement to be kept by U.S. Distributor.[1] The pamphlet containing petitioner's retained duplicate original was introduced in evidence. American Gold was also a party to the Territorial Distributorship Agreement and is referred to therein as "Importer," and U.S. Distributor is referred to as "Distributor." The Territorial Distributorship Agreement (referred to hereinafter sometimes merely as the agreement) provides in principal part as follows:

> TERRITORIAL DISTRIBUTORSHIP AGREEMENT
>
> The undersigned represent and agree as follows:
>
> * * * * * * *
>
> 3. PRODUCT of IMPORTER includes the following:
>
> *Product A* includes a combination of (1) a Diamond; (2) A quality Analysis Certificate from [a] * * * recognized independent gemological laboratory * * * [and] (3) One Certificate from an independent gemological laboratory or an independent appraiser which verifies that the Diamond matches the contents of the Quality Analysis Certificate with a statement of its Estimated Market Retail Price.
>
> *Product B* includes a combination of (1) an investment grade quality Ruby, or an investment grade quality Sapphire, or an investment grade quality Emerald; (2) a Quality Analysis Certificate from [a] * * * recognized independent gemological laboratory * * * [and] (3) One Certificate from an independent gemological laboratory or an independent appraiser which verifies that the gem matches the contents of the Quality Analysis Certificate with a statement of its Estimated Market Retail Price.
>
> *Product C* includes a combination of (1) a Precious gem imported from Brazil; [and] (2) a statement from an independent appraiser of its Estimated Market Retail Price.
>
> A Precious Gem imported from Brazil is defined as one of the following Gems: Aquamarine, Amethyst, Citrine, Garnet, Kunzite, Opal, Precious Tourmaline, Rubellite, and Precious Topaz.
>
> *Product D* includes a combination of (1) a Precious Gem originating in Australia, India, Africa, Thailand, Burma or Sri Lanka (formally [sic] Ceylon), and other areas; [and] (2) a statement from an independent gemological laboratory or from an independent appraiser of its Estimated Market Retail Price.
>
> A Precious Gem originating in Australia, India, Africa, Thailand, Burma or Sri Lanka (formally [sic] Ceylon) is defined as one of the following: Amethyst, Aquamarine, Citrine, Emerald, Garnet, including Green Garnet, Opal, Precious Tourmaline, Ruby, Sapphire, and Tanzanite.

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[1] Certain "Instructions" at the bottom of Exhibit G to the agreement, *infra*, p. 86, would appear to indicate that there was still a third copy that was to be sent to an escrow company in Carson City, Nevada.

Product E - Fine Jewelry.

Product F - Costume Jewelry.

Product G - Such exclusive rights to purchase Precious Gems and commercial and industrial gem materials as IMPORTER may acquire, on a prorated basis with all other TERRITORIAL DISTRIBUTORS during the term of any TERRITORIAL DISTRIBUTORSHIP. * * *

4. IMPORTER has delegated to DISTRIBUTOR the exclusive right to distribute worldwide one hundred (100%) percent of its PRODUCT as is described in Paragraph 3 hereof for a period of fifty years beginning with July 1, 1979.

5. DISTRIBUTOR will not compete with any TERRITORIAL DISTRIBUTOR and agrees that all of the PRODUCT to which it is entitled pursuant to Paragraph 4 will be made available exclusively to TERRITORIAL DISTRIBUTORS.

6. DISTRIBUTOR hereby transfers to TERRITORIAL DISTRIBUTOR an exclusive TERRITORIAL DISTRIBUTORSHIP permitting TERRITORIAL DISTRIBUTOR to engage in the business activity as set forth herein within the Specified Territory, including the right to distribute the PRODUCT to retail and wholesale outlets within the Specified Territory.

7. TERRITORIAL DISTRIBUTOR is entitled, along with all other TERRITORIAL DISTRIBUTORS within the United States, to purchase the entire supply of the PRODUCT of IMPORTER on a pro rata basis with all other TERRITORIAL DISTRIBUTORS.

8. IMPORTER has an arrangement to acquire Diamonds purchased by several "sight buyers" from the Central Selling Organization and from other primary sources. * * *

9. IMPORTER has relationships with major volume-suppliers of Colored Precious Gems and these relationships will form a basis for sales by IMPORTER to TERRITORIAL DISTRIBUTORS at favorable prices.

10. IMPORTER has relationships with suppliers of Costume Jewelry, and these relationships will form a basis for sales by IMPORTER to TERRITORIAL DISTRIBUTORS at favorable prices.

11. IMPORTER is a manufacturer of fine jewelry.

12. IMPORTER is continuously advised by individuals who are highly skilled and pre-eminent in their fields of the economics of the gem industry, the political considerations affecting the gem industry, purchasing of gems, fair standards of sales, gemological analysis and quality grading of gems, and appraisal of Diamonds and other Precious Gems. * * *

13. WARRANTIES

* * * * * * *

B. DISTRIBUTOR warrants that:

In the event TERRITORIAL DISTRIBUTOR adopts the accrual method of accounting for the business covered by this TERRITORIAL DISTRIBUTORSHIP AGREEMENT, DISTRIBUTOR will supply at its expense a defense of the tax treatment of TERRITORIAL DISTRIBUTOR projected in the Tax Opinion Letter. Such support will include representation at the Internal Revenue Service level upon the issuance of a 30-day letter from the Internal

Revenue Service (IRS Form 950(DO) or its equivalent), and defense in the United States Tax Court and the United States Court of Appeals.

* * * * * * *

As a foundation for said warranties, a Trust has been established wherein the Trustee holds real property consisting of 2,000 acres of land appraised at $8,000,000 which is encumbered in the approximate amount of $3,000,000. Trustor has transferred to Trustee the power to obtain the reconveyance of approximately 150 acres of said land from the effect of any encumbrance thereon, and Trustee shall cause to be released said 150 acres of said land from the effect of any encumbrance and thereafter shall hold said land free and clear of any encumbrance until it is sold pursuant to the terms of said Trust. Said 150 acres to be so released and so held have been appraised at $4,000 per acre. All of this property is residential and/or commercial. The Trustee has been instructed to sell or exchange any amount of said real property in order to pay TERRITORIAL DISTRIBUTORS any damages they may suffer as the result of the breach of the warranty expressed in Paragraphs 13 A and B.

Trustee has been instructed to continue with planning and engineering of said real property to enable the Trustee to subdivide and sell parcels thereof.

Trustee has been instructed to invest the surplus cash from such sales in Diamonds and Precious Gems and to hold, sell, and reinvest in Diamonds and other Precious Gems in order to maintain a fund in the form of Diamonds and Precious Gems of at least $1,000,000 in Market Value.

The Trustee shall release the real property remaining in the Trust when Trustee holds an inventory of at least $1,000,000 in Market Value of Diamonds and other Precious Gems as defined in this Agreement.

Said inventory of Diamonds and Precious Gems shall be held and managed by Trustee by selling and reinvesting in Diamonds and other Precious Gems during the existence of this Agreement.

14. The PRODUCT will be provided to TERRITORIAL DISTRIBUTOR at a price as follows:

Product A - Either approximately one hundred ten (110%) percent of the average price charged by major diamond cutters on 47th Street in New York City * * * or, at the option of IMPORTER, forty (40%) percent of the stated Estimated Market Retail Price as of the date of the statement.

Product B - From thirty-five (35%) percent to forty (40%) percent of the stated Estimated Market Retail Price provided by an independent gemological laboratory or an independent appraiser.

Product C - From twenty (20%) to thirty (30%) percent of the stated Estimated Market Retail Price provided by an independent gemological laboratory or an independent appraiser.

Product D - From twenty (20%) percent to thirty (30%) percent of the stated Estimated Market Retail Price provided by an independent gemological laboratory or an independent appraiser.

Product E - From thirty-five (35%) percent to forty (40%) percent of the suggested retail price.

Product F - Twenty (20%) percent of Suggested Market Retail Price.

Product G - A price which does not exceed IMPORTER'S cost plus fifteen (15%) percent.

15. The full purchase price provided in Paragraph 14 for PRODUCT must be deposited with IMPORTER at the time of the order.

16. TERRITORIAL DISTRIBUTOR agrees to make prepayments to DISTRIBUTOR on all Principal Sum Annual Installment Promissory Notes delivered from TERRITORIAL DISTRIBUTOR to DISTRIBUTOR pursuant to this TERRITORIAL DISTRIBUTORSHIP AGREEMENT. Said prepayments will be in the amount of ten (10%) percent of the total cost of TERRITORIAL DISTRIBUTOR for all PRODUCT purchased from IMPORTER pursuant to Paragraph 14.

A TERRITORIAL DISTRIBUTOR will be instructed by DISTRIBUTOR as to the method of payment to be utilized with reference to this prepayment requirement. All prepayments received will be applied to Promissory Notes, whether Recourse or Non-Recourse in chronological order. This prepayment requirement will terminate on December 31, 2004.

* * * * * * *

19. This Agreement has employed the term "Estimated Market Retail Price." Depending upon the appraiser involved, similar terms may be substituted, including: (1) Estimated Retail Replacement Value; (2) Estimated Retail Replacement Cost; (3) Appraised Retail Value; (4) Total Estimated Value Based on Retail Replacement; (5) Market Value.

20. The term of the TERRITORIAL DISTRIBUTORSHIP will be 35 years commencing on the date of this agreement.

21. The TERRITORIAL DISTRIBUTORSHIP will include the Territory described in Exhibit D.

22. TERRITORIAL DISTRIBUTOR is authorized to appoint agents and dealers within the Territory.

23. In consideration of the Territorial Distributorship transferred herein, TERRITORIAL DISTRIBUTOR SHALL pay to DISTRIBUTOR a Principal Sum as set forth in Exhibit A, Part I, and purchase PRODUCT from IMPORTER as set forth in Exhibit A, Part II.

* * * * * * *

25. TERRITORIAL DISTRIBUTOR specifically represents and understands as follows:

(a) That he has sufficient business experience to operate his Territorial Distributorship.

(b) That he has the financial capacity to develop the Territory.

(c) That he intends to personally promote the PRODUCT in the Territory acquired or cause promotion to be effected within the Territory.

(d) That, as a TERRITORIAL DISTRIBUTOR, he will not be entitled to participate with other TERRITORIAL DISTRIBUTORS with reference to expenses, profits, or otherwise. Further, that his profits, if any, earned as a TERRITORIAL DISTRIBUTOR will depend solely on his own management and marketing ability, and not that of the DISTRIBUTOR or the IMPORTER or any affiliate.

(e) That he has read the Tax Opinion Letter addressed to DISTRIBUTOR by the law firm of SOMERS & ALTENBACH, and he understands that the tax incidents involving his becoming a TERRITORIAL DISTRIBUTOR may vary from those of other individual TERRITORIAL DISTRIBUTORS, and there can be no assurance that the Internal Revenue Code or the Regulations thereunder, as they exist or as they may be amended, will allow any TERRITORIAL DISTRIBUTOR the tax benefits referred to in the Tax Opinion Letter.

(f) That he believes there is a realistic possibility of profits from the operation of the TERRITORIAL DISTRIBUTORSHIP.

(g) That, as a TERRITORIAL DISTRIBUTOR, he will *not* be entitled to utilize any trademark or trade name of DISTRIBUTOR or IMPORTER.

(h) That the MINIMUM PRODUCT PURCHASE REQUIREMENT of Colored Precious Gems is not purchased as a part of the inventory of the TERRITORIAL DISTRIBUTOR for resale, and that the TERRITORIAL DISTRIBUTOR will continue to hold those Colored Precious Gems for purpose of display to prospective customers.

The agreement incorporates a "Security Agreement" which provides that any nonrecourse note used to pay a portion of the "Principal Sum" would be secured by an interest in all of the territorial distributor's rights in his distributorship, including an interest in all "receivables and inventory owned * * * pursuant to the" territorial distributorship. The principal sum is the amount the territorial distributor is to "pay" for his territorial distributorship. As will appear more fully hereinafter, no such "Principal Sum" is set forth in the body of the agreement.

Following the Territorial Distributorship Agreement and the Security Agreement are a number of exhibits designated A through F, applicable to either agreement wherever reference is made in either to an exhibit. Part I of Exhibit A specifies the requirements for payment of the principal sum. It obligates the territorial distributor to deliver, upon execution of the agreement, a recourse note for one-twelfth of the principal sum. Thereafter, on December 1 of each of the following 11 years starting with 1980, the territorial distributor is to tender cash or a recourse note or a nonrecourse note, or some combination of any two or all three, totaling one-twelfth of the principal sum. Although Exhibit A refers to the "Principal Sum" in accordance with paragraph 23 of the Territorial Distributorship Agreement, it does not set forth the amount of that "Principal Sum" but merely makes reference to Exhibit D, which purportedly fixes the amount of the "Principal Sum."

Part II of Exhibit A binds the territorial distributor to purchase certain "Minimum Product" from American Gold. In 1979, the territorial distributor is required to buy, for cash:

> A. * * * Product C or D (Colored Precious Gems) having an aggregate appraised Estimated Market Retail Price of not less than twenty-five (25%) percent [of that portion] of the Principal Sum Annual Installment [paid in cash or financed with a recourse note], or, in the alternative;
>
> B. * * * Product C or D (Colored Precious Gems) having an aggregate Estimated Market Retail Price of not less than $5,000 *and* Product A (Diamonds) for the difference between the minimum cash purchase provided for in Paragraph A and the cost of Product C or D multiplied by 2.5.

Unlike the favorable prices at which gems would be sold generally to the territorial distributor for resale, the prices to be paid for the minimum product were fixed in the agreement, as follows:

> C. With reference to the Minimum Product Purchase Requirement only, the price for Product C or D (Colored Precious Gems), will be one hundred (100%) percent of its Estimated Market Retail Price. With reference to the Alternative Minimum Product Purchase Requirement including Product A (Diamonds) and Product C or D, the price for Product A will be fifty eight (58%) percent of its Estimated Market Retail Price.

In the years subsequent to 1979, the same formula for purchase of minimum product appears to have been applicable except that the territorial distributor is explicitly relieved of the requirement to purchase any product C or D. In this respect, paragraph D of part II of Exhibit A, after setting forth the minimum product purchase requirement, states "except that *no* minimum purchase of Product C or D will be required." However, paragraph E of part II of Exhibit A further indicates that in such later years the "selection of the particular PRODUCT A, C or (D) for the purpose of the Minimum Product Purchase Requirement * * * shall be at the discretion of Importer." The seeming or possible contradiction between the statement "that *no* minimum purchase of Product C or D will be required" and American Gold's right to determine which product must be purchased, is unexplained.

Exhibits B and C are the "FORM" recourse promissory note and the "FORM" nonrecourse promissory note, respectively, to be used by the territorial distributor in making his principal sum payments to U.S. Distributor. Each note is payable in five equal annual installments commencing on December 31, 2004, and bears "Interest (not compounded) at the rate of six (6) percent per annum * * * payable in full with the first principal installment." Prepayments are allowed and, indeed, are required by paragraph 16 of the Territorial Distributorship Agreement, but are first to be applied against interest. However, such prepayments are required only to the extent that (and measured by a percentage of) any product—other than minimum product—purchased by the territorial distributor from American Gold. But there is no requirement that the territorial distributor purchase any product whatever other than minimum product, and no prepayment is required in connection with the purchase of minimum product. Further, since the purchase of minimum product is required only in an amount equal to one-fourth of that part of the annual installment paid for the distributorship in cash or by recourse note, and since the distributor has the option of paying every installment in full after 1979 with a nonrecourse note, he is under no obligation whatever to purchase minimum product after 1979 to the extent that he chooses to use nonrecourse notes. The recourse note is unsecured, but liability thereon is "not limited to any prepayment obligation, specific collateral or otherwise." The nonrecourse note is secured only by the Security Agreement.

Exhibit D is a form for identifying the territorial distributor's assigned distributorship territory, "Minimum Product Purchase Requirement," and principal sum. It was left blank at the time the Territorial Distributorship Agreement was purportedly entered into by petitioner, U.S. Distributor, and American Gold. No specific territory was then[2] assigned to petitioner, nor was the amount of the "Principal Sum" set forth as called for by Exhibit A.

Exhibit E, a duplicate of Exhibit B, is the form recourse note to be actually executed and used in making the first principal sum payment, the payment due upon the execution of the agreement. Exhibit E in the agreement purportedly entered into by petitioner was filled in and dated by him on December

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[2] As will appear hereinafter, there were only two possible dates when the agreement might arguably have been entered into: Dec. 27, 1979, and Feb. 29, 1980. At neither of those dates was there any executed Exhibit D identifying any territory purportedly assigned or to be assigned to petitioner.

27, 1979. Since the purported purchase price for his distributorship was $384,000 (an amount confusingly not appearing anywhere in the agreement),[3] the principal sum of the Exhibit E recourse promissory note signed by petitioner was, in accordance with Exhibit A, one-twelfth of that $384,000 purchase price, namely, $32,000.

Although the Territorial Distributorship Agreement begins with the words "The undersigned represent and agree as follows," nowhere in the body of that agreement is the identity of the territorial distributor disclosed or referred to, nor is that agreement signed at the end thereof by any of the parties, nor is it dated either in the body or at the end thereof. The only place where there is provision for date and signatures of the "undersigned" parties in respect of the agreement, itself, is Exhibit F.

Exhibit F was a blank form, which, prior to being filled in and signed by petitioner, read as follows:

EXHIBIT F

The undersigned acknowledges that he has either read or has had available to him for reading all of the "TERRITORIAL DISTRIBUTORSHIP CONTRACT DOCUMENTS" which consist of a SUMMARY OF BUSINESS OPPORTUNITY, a TAX OPINION LETTER, and a TERRITORIAL DISTRIBUTORSHIP AGREEMENT. Signatures on this page relate to the entire TERRITORIAL DISTRIBUTORSHIP AGREEMENT, including the SECURITY AGREEMENT, and to EXHIBITS A, B, C, D, E, F, and G, and the signatures signifiy that the signer has read and understands the entire TERRITORIAL DISTRIBUTORSHIP AGREEMENT, including the EXHIBITS attached thereto.

In the event that Territorial Distributor makes no choice of total Territory, or that the Territory chosen is not available, DISTRIBUTOR is authorized to designate a Territory for him.

____

Signature of TERRITORIAL
DISTRIBUTOR and DEBTOR

* * * * * * *

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[3] The purchase price does not appear in the body of the agreement, and although there is a place therefor on the form constituting Exhibit D, that exhibit was left entirely blank, as noted above, at whatever date the agreement may conceivably be considered as having been entered into. See note 2 *supra*. As will appear hereinafter, the amount was entered on two different Exhibits D dated July 30, 1980, and Oct. 22, 1980, which were inconsistent with each other in the identification of the territory purportedly assigned to petitioner.

ACCEPTANCE

The undersigned hereby accepts the above named as a TERRITORIAL DISTRIBUTOR and DEBTOR.

Executed at Carson City, Nevada as of ____________________

U.S. DISTRIBUTOR, INC. AMERICAN GOLD & DIAMOND CORPORATION

By ____________________ By ____________________

Petitioner signed and dated Exhibit F on December 27, 1979, but the portion of Exhibit F calling for acceptance and signature on behalf of the other parties to the agreement, namely, U.S. Distributor and American Gold, was left blank. Another copy of Exhibit F was executed on February 29, 1980, on behalf of U.S. Distributor and American Gold. That copy was sent to petitioner; it contains petitioner's signature, but there is no date opposite that signature. That second copy of Exhibit F has been stapled to the inside cover of petitioner's retained "Contract Documents" pamphlet containing the Territorial Distributorship Agreement.

Exhibit G is a "RECEIPT FOR PAYMENT TO INDEPENDENT CONTRACTOR," to be used to evidence the territorial distributor's cash and/or recourse note payments to Professional Escrow Service, Inc. ("Escrow" or the "Escrow company"), which apparently was to act as escrow agent for American Gold and U.S. Distributor. Prior to being filled in, Exhibit G read as follows:

EXHIBIT G

RECEIPT FOR PAYMENT TO INDEPENDENT CONTRACTOR

The undersigned receipts for a check payable to Professional Escrow Service, Inc., in the amount of $ ____________ and a RECOURSE NOTE in the amount of $ ____________. The check and the RECOURSE NOTE mentioned above shall be mailed forthwith to Professional Escrow Service, Inc., 300 Hot Springs Road, Suite 20, Carson City, Nevada 89701.

____________________ ____________________

Signature of INDEPENDENT CONTRACTOR Print Name

____________________ ____________________

Street Address City - State - Zip

( ) ____________________

Telephone Number

INSTRUCTIONS TO EARL MARTINSON, INC., REPRESENTATIVE:

You have two copies of the TERRITORIAL DISTRIBUTORSHIP CONTRACT DOCUMENTS with the same number. Exhibits D, E, F and G in each Manual must be filled out and fully executed. One of the Manuals is to be given to the TERRITORIAL DISTRIBUTOR, and the other is to be mailed to Professional Escrow Service, Inc. After acceptance by DISTRIBUTOR and IMPORTER an executed copy of Exhibit F will be mailed to the TERRITORIAL DISTRIBUTOR for insertion in the copy of the Contract Documents retained by the TERRITORIAL DISTRIBUTOR.

It was filled in (by hand) solely by insertion of the amount of $1,000 in respect of the check. Everything else was left blank. Earl Martinson, Inc., is not identified in the record, but seems in some fashion to have assisted in the marketing of the program.

At the time that petitioner signed the Exhibit E $32,000 promissory note, December 27, 1979, he was theoretically obligated by Exhibit A (if the Territorial Distributorship Agreement were to be regarded as having then been fully in effect) to purchase minimum product from American Gold in an amount of not less than 25 percent of that note, i.e., not less than $8,000. The $1,000 check referred to in Exhibit G was intended to be in partial fulfillment of that obligation. And although Exhibit A to the agreement required that the minimum product be purchased for cash, petitioner at the same time on December 27, 1979, executed a note in the amount of $7,000 for the remainder of his obligation in respect of the $8,000 minimum product purchase requirement. That $7,000 note bore interest at the rate of 10 percent a year. It is petitioner's position that the requirement of purchase for cash was orally waived to the extent of the $7,000 note. The $7,000 note was payable to the Escrow company, and was due on December 31, 1979. It has not been paid.

At the time of petitioner's signing of the various documents referred to above on December 27, 1979, there was present John Knowles, then president and authorized representative of U.S. Distributor. Mr. Knowles did not then sign the agreement or any document purporting to bind U.S. Distributor. Among the documents delivered to U.S. Distributor or the Escrow company at that time was a worksheet identifying the territory or territories being requested by petitioner. He purports to have relied upon alleged oral assurances by Mr. Knowles that the territory primarily desired by him, near his office in Encino, California, would be assigned to him. However, as indicated above, when Exhibit F was finally executed on behalf of U.S. Distributor and American Gold on February 29, 1980, no territory whatever was assigned to petitioner. At that time, Mr. Knowles signed for U.S. Distributor in his capacity as president, and a person named Glen Symons signed as "attorney-in-fact" for American Gold.

On December 28, 1979, petitioner delivered a $100 check to Gem-mart in payment of fees "due" under the terms of a "Consulting Contract." However, that contract was not executed until February 29, 1980, at the same time that the basic agreement between petitioner and U.S. Distributor and American Gold was executed. Under the "Consulting Contract," Gem-Mart was to assist petitioner in the merchandising of American Gold's product, inter alia, by negotiating with jewelers on petitioner's behalf. The contract specifically declared that Gem-Mart was "retained to produce results" but that Gem-Mart would make no "business decisions" and would have no power to "contract" on petitioner's behalf.[4] In return for Gem-Mart's services in arranging sales, petitioner agreed to pay Gem-Mart 50 percent of gross profits.

Petitioner's $384,000 purported purchase of the distributorship was the largest purchase he had ever made. In deciding whether to purchase a distributorship, petitioner did not investigate any other gem distributorship program.

At the time petitioner signed the agreement, he had only "reasonable" assurances as to the area in which he would be the exclusive distributor of American Gold's product. Although he had been informally advised that he would receive a territory within Zip Code 91436 in Encino, California, one within Bethesda, Maryland, and one within Galway, Ireland, such assignments were not guaranteed and he could be allotted other areas. And, as noted above, Exhibit D to the executed agreement (whether the date of execution be treated as December 27, 1979, or February 29, 1980) which should have identified petitioner's exclusive territory, was left blank.

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[4] The evidence, however, establishes that Gem-Mart did in fact make "business decisions" and carried out transactions without consulting petitioner in connection with any sales arranged by it. As will appear hereinafter, no sales were in fact made in petitioner's exclusive territory and the sales actually made are referred to hereinafter as "random" or "casual" sales.

Petitioner was not finally assigned his exclusive territory until October 1980. On August 25, 1980, petitioner received a completed Exhibit D dated July 30, 1980, indicating that his territory for distributing American Gold's product would be the areas defined by Zip Codes 91316 in Encino, California, and 20014 in Bethesda, Maryland, and the cities of Galway and Waterford, Ireland. An "Addendum" to this exhibit which "clearly sets forth * * * the jewelry outlets that comprise * * * [petitioner's] Territorial Distributorship," listed the names of four outlets each in the foregoing Encino and Bethesda zip code areas.

However, on October 24, 1980, petitioner received a letter advising him that he had been incorrectly assigned jewelry outlets and, thus, was then allotted "two new Zip Codes in Bethesda, each of which has only one jewelry outlet in it, and * * * two additional outlets in Encino." An enclosed "new" Exhibit D, dated October 22, 1980, listed four zip code areas—91316 and 91436, in Encino, and 20015 and 21237 in Bethesda—and the cities of Galway and Waterford in Ireland. The "Addendum" to this exhibit recorded five outlets in the 91436 Zip Code and one in each of the other three zip code areas. Only one of the outlets listed in the latter "Addendum," the one in the 91316 Zip Code area, appeared on the earlier list. Petitioner does not now know whether any of the jewelers named on the addendum are currently in business. In explaining the need for changing petitioner's territory, the second letter (signed by Glen Symons for the Escrow company) stated that "we discovered that Penni had been assigning jewelry outlets incorrectly." The identity of Penni, her position, and her authority to make assignments of territories were undisclosed.

Neither of the above-described Exhibits D made clear whether petitioner had been assigned specific geographic areas or simply certain outlets within such areas. At trial, petitioner was unable to resolve this confusion. Indeed, he was uncertain as to what the status of his distributorship would be if those outlets listed on the "Addendum" closed or moved from his assigned exclusive territory, or whether he was exclusively entitled to distribute to outlets thereafter commencing business within those areas. Also, although he "understood" that he was allowed to sell directly to individuals within his territories, he was not sure whether the agreement permitted such activity.

Petitioner remained a territorial distributor through the date of trial. He discharged his obligation to pay one-twelfth of his principal sum amount in 1980 by delivering to U.S. Distributor an agreement Exhibit B recourse promissory note in the amount of $16,000 and an agreement Exhibit C nonrecourse promissory note also in the amount of $16,000. Each note was dated December 31, 1980, was interest-bearing, and was payable in five equal annual installments beginning December 31, 2004.

In approximately September of 1981, petitioner executed a "Modification of Contract" (modification or Modification Agreement) which altered essential terms of the agreement. The principal changes made by the modification included the elimination of the interest provisions of the recourse and nonrecourse notes used to finance principal sum payments, an increase in the price to territorial distributors of products C and D, and a reduction, in some instances, of the prepayment amount required by paragraph 16 of the agreement.[5] The purpose of these alterations was to conform the contractual terms of the agreement as signed by petitioner in 1979 with later agreements made during 1980 and 1981 with other, new territorial distributors. Apparently, the later agreements differed in many ways from that signed by petitioner.

Attached to the Modification Agreement were copies of seven promissory notes, six of which petitioner had executed. Three of these notes, two "recourse" in the amounts of $32,000 and $16,000 and one "nonrecourse" in the amount of $16,000, were intended as substitutes for the promissory notes petitioner used in 1979 and 1980 in making his principal sum payments. These three new notes reflected the changes made by the Modification Agreement, including the elimination of the interest requirement. They were "Dated as of:" January 1, 1981, and, like the old notes, were payable in five annual installments, but to begin on December 31, 2006, two years later than the old notes. Two other similar notes, one "recourse" and one "nonrecourse," each in the amount of $16,000 and each "Dated as of" December 31, 1981, were in payment of petitioner's 1981 principal sum obligation. A final note, carrying a 10 percent per annum interest rate but no due date, in the amount of $4,000 was "For use in 1981 for Minimum Product Purchase."

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[5] Par. 16 of the agreement provided for prepayments on "all Principal Sum Annual Installment Promissory Notes * * * in the amount of ten (10%) percent of the total cost of" product purchased from American Gold. A statement within the body of the modification read, in part, "prepayment requirements on notes when purchasing product have been reduced from ten and twenty percent to five and ten percent." Promissory notes attached to the modification contained a paragraph which called for prepayments which varied depending upon the type of product a distributor purchased. However, see *supra*, p. 83,as to the illusory character of the prepayment requirement. The reduction in the modification would be applicable only if a territorial distributor purchased any product (other than minimum product), and he was under no obligation to make any such purchase.

The Modification Agreement and its attachments could at best be described as confusingly inexact and unprofessional. For example, it makes reference to certain pages and paragraphs allegedly in the agreement, but these references in no way correspond with the appropriate paragraphs in the agreement. However, even though petitioner "acknowledged that he * * * [had] read the * * * [m]odification and * * * compared the language of his original agreement with the language of the modification," he could not resolve the confusion, nor could he recall "noting" the inaccuracies at the time he signed the modification. Also, a paragraph contained in the attached "nonrecourse" notes reads:

> This is a Non-Recourse Note. *Maker's liability is not limited to any prepayment obligation, specific collateral or otherwise.* [Emphasis supplied.]

Petitioner concedes that this is the definition of a recourse, not a nonrecourse, note (indeed, the emphasized sentence above is found verbatim in the recourse notes), but he could not explain this glaring inconsistency.[6] A further instance of drafting nonsense is a provision in the Modification Agreement purporting to modify a 20-percent prepayment requirement (see note 5 *supra*, p. 89) although there is admittedly no such 20-percent prepayment obligation in the agreement.[7]

Petitioner has made no attempt to retrieve the original notes replaced pursuant to the Modification Agreement. He regarded the notes as being possibly negotiable, and indicated that, as a lawyer, in the ordinary course of business, he would never substitute a new promissory note for an old note without having the old note returned. Nevertheless, he has not recovered possession of those notes replaced pursuant to the Modification Agreement, nor does it appear that he made any effort to obtain them. His apparent indifference to leaving outstanding multiple copies of these executed notes representing the same liability was in marked contrast to his attitude in respect of possible outstanding duplicate copies of his executed Exhibit E recourse promissory note. Since the agreement was executed purportedly in duplicate original and since it was petitioner's retained original copy (containing a signed Exhibit E recourse promissory note) that was before the Court, he was questioned whether he had signed both an original as well as a duplicate Exhibit E recourse promissory note. He replied "Of course not. I wasn't that crazy."

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[6] Upon being shown this inconsistency at the trial, petitioner exclaimed, "I'll be darned."

[7] It is conceivable that the 20-percent figure appears in the "Contract Documents" pamphlet that was used for 1981 and possibly for 1980. However, the Modification Agreement as it relates to petitioner should properly have been made applicable to the Territorial Distributorship Agreement signed by him that was contained in the 1979 version of the "Contract Documents" pamphlet. No copy of the 1980 or 1981 "Contract Documents" pamphlet was attached to the Modification Agreement or made available to the Court.

Petitioner discharged his yearly obligation to pay one-twelfth of his principal sum in 1982 and 1983 by delivering each year to U.S. Distributor a nonrecourse note in the amount of $32,000. The 1982 nonrecourse note was a filled-in copy of the agreement Exhibit C form nonrecourse note with the provisions relating to interest crossed out. This note was dated December 27, 1982, payable in five equal annual installments commencing December 31, 2004. The 1983 nonrecourse note was substantially different from both the Exhibit C form note and the nonrecourse notes attached to the Modification Agreement. The five equal annual payments on this note were to begin on December 31, 2008, and prepayments were required in an amount other than that required by the agreement as altered by the Modification Agreement. This note was "Dated as of" October 24, 1983.

The agreement required petitioner to purchase, for cash, minimum product with an "Established Market Retail Price" of not less than 25 percent of that part of his annual principal sum payment paid in cash or financed with a recourse promissory note. Thus, petitioner should have purchased, for cash, minimum product with a "Retail Price" of at least $8,000 in 1979, $4,000 in 1980, and $4,000 in 1981. However, he actually purchased only $1,000 of minimum product for cash.

He neither purchased nor received any further minimum product.

In 1979, petitioner purported to meet his minimum product purchase requirement by tendering to the Escrow company the $1,000 check and the $7,000 promissory note described above. See p. 86 *supra*. Thereafter, on April 28, 1980, petitioner received minimum product consisting of nine product C type gems for his $1,000 check.

Aside from the nine Product C type gems received in April 1980, petitioner never obtained further minimum product, which, pursuant to the agreement, could not be resold. Shortly after entering into the agreement, he arrived at an oral understanding with Crooks that relieved him of his obligation to make any further purchases of minimum product.

Notwithstanding his apparent agreement with Crooks, petitioner tendered to the Escrow company one promissory note in 1980 and one in 1981, each in the amount of $4,000, in respect of his minimum product purchase requirement.[8] However, an "Agreement," in evidence, referring to the "promissory note executed by [petitioner] * * * on December 31, 1980," read, in pertinent part: "AMERICAN GOLD & DIAMOND CORPORATION agrees that the dollar amount of any purchase of PRODUCT * * * by the maker of the promissory note shall be credited as a payment on said promissory note." This "Agreement" was "Dated: As of" December 31, 1980, and was signed for American Gold by Crooks as "Attorney in Fact." The $4,000 promissory note dated December 31, 1980, has not been returned to petitioner.

No writing similar to that of the foregoing in respect of petitioner's 1980 minimum product purchase requirement exists with respect to either his 1979, $7,000 or 1981, $4,000 obligations. At trial, petitioner initially testified that he "consider[ed] [himself] * * * relieved of the obligation to comply with the terms of" the 1979 note, but was unable to state that he had reached such an understanding with anyone authorized to represent American Gold. (Although petitioner testified about an oral understanding with Crooks, see *above*, there was no indication that Crooks represented or even purported to represent American Gold in this connection.)

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[8] The note for 1981 was that $4,000 note attached to the Modification Agreement. See *supra*, p. 90.

Later, petitioner changed his testimony, admitting, instead, that "Although I have not had the opportunity to check with American Gold * * * to see what their attitude is, as to whether or not they feel I still owe them the $7,000 and whether or not they still owe me the minimum product if I pay it. I just don't know the current status of that. I haven't had a chance to discuss it." He did "believe," however, that the 1981 $4,000 note "has been satisfied." Petitioner has not attempted to learn whether the 1979, $7,000 note has been canceled.[9]

In connection with petitioner's transactions involving gemstones, he adopted the fictitious name "Euhedral Enterprises" (Euhedral). In December 1980, he registered such name with the Los Angeles City County Recorder and applied for and received "City of Los Angeles Business Tax Registration Certificate[s]" authorizing Euhedral to make retail and wholesale sales. In addition, he applied for and, in 1981, received a "Seller's Permit" from the California State Board of Equalization. Also, petitioner purchased stationery and business cards bearing Euhedral's name and opened checking accounts in its name in California and North Dakota,[10] During 1980, 1981, 1982, 1983, and 1984, petitioner paid business taxes to the city of Los Angeles in the amounts of $38.75, $47.95, $60.67, $52.50, and $54.93, respectively. During 1981 through 1983, he filed quarterly "State, Local and District Sales and Use Tax Return[s]" with the California Board of Equalization, but, since he had no sales subject to California sales tax, such returns showed no tax liability. In Maryland where he had no sales, he neither filed any sales tax returns nor paid any sales taxes.

Petitioner has never, at least until the date of trial, sold any of American Gold's product in any part of his assigned exclusive territory. Although he was aware that, notwithstanding his contract with Gem-Mart, he initially had to approach prospective purchasers, he has never contacted, either in person or otherwise, any jeweler in his assigned territory for the purpose of selling or even exploring the possibility of selling American Gold's product. At the time he entered into the Territorial Distributorship Agreement, he had no intention of then visiting any jeweler in Bethesda or Ireland. Currently, he states that he has no interest in approaching any jeweler until the diamond market "improves" and has not acquired any "display" diamonds to use to arouse purchasers' interest. He has never taken custody of any gemstones other than the nine minimum product items previously discussed, which he had purchased for $1,000.

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[9] No evidence was presented concerning whether the 1981 $4,000 note has been canceled.

[10] Petitioner opened a checking account in 1983 in North Dakota in connection with a relationship he established with Warren Johnson, a traveling salesman, who, as set forth more fully hereinafter, sold jewelry in North Dakota, Minnesota, and Wisconsin.

During 1980 petitioner from time to time received form communications from Gem-Mart which were apparently being sent to all other territorial distributors. In general, these communications announced the availability of various gems for purchase by the territorial distributors which Gem-Mart would in turn undertake to resell in accordance with the "Consulting Contract" between the individual territorial distributor and Gem-Mart. In some of the communications there was pointed reference to the tax benefits and the importance of showing some sales activity before the end of the year in order to obtain full tax benefits. Petitioner nevertheless made no purchases of any gems for resale at any time until December 1980.

In response to a communication from Gem-Mart dated December 8, 1980, announcing the availability of certain colored gems to be imported from Brazil, petitioner sent a letter, also dated December 8, 1980, to Frank Davis as president of Gem-Mart in Provo, Utah, transmitting a $15,000 check payable to "Gem-Mart Trust Fund." He stated that the funds transmitted were "to be applied to your program concerning the import and sale of colored stones." He added that it was his understanding that Gem-Mart would be able to conclude a purchase and sale of colored stones on his behalf prior to the close of the year, obviously intending thereby to support a claimed deduction for 1980. On or about December 12, 1980, Gem-Mart, without any further consultation with petitioner, used $10,366.50 of this money to purchase eight noninvestment grade diamonds, but not any imported colored Brazilian gems. By the end of December 1980, it sold some of the diamonds for a total of $8,923. Petitioner determined that the cost of the diamonds thus sold was $7,931. None of the stones was sold to any purchaser within petitioner's assigned exclusive territory, nor does it appear that any effort was even undertaken to make any such sale in such territory.

Gem-Mart also sold gemstones on petitioner's behalf through a joint venture program it created in 1981. Under this program, Gem-Mart pooled the resources of participating territorial distributors and then bought and sold gemstones on behalf of all participants in proportion to their respective interests in the joint venture. Each participant was credited with a proportionate share of the venture's sales and profits. As previously noted, petitioner in December 1980 had transmitted $15,000 to Gem-Mart for use in the purchase and sale of gemstones on his behalf; and in February 1983, he transmitted an additional $5,000 to be added to the amount credited to him by Gem-Mart for use in the joint venture. None of Gem-Mart's sales on behalf of the joint venture was made to purchasers in petitioner's assigned exclusive territory.

Petitioner was also involved in a program, "[b]y virtue of [his] * * * contractual agreement with Gem-Mart," through which he, along with other interested territorial distributors, financed jointly the purchase of inventory to be placed for sale with the Philip Michaels Jewelry Store (Philip Michaels) located inside the Denver, Colorado, Marriott Hotel. Petitioner, in February 1983, sent a $5,000 check to Gem-Mart representing his pro rata investment in that project. Participants in this program shared part of the profit on the sale of the financed inventory. Philip Michaels was owned by a corporation, DaMar Management Co.'s, Inc., which in turn was owned, in part, by Davis. Davis' indirect ownership of Philip Michaels was not disclosed to the territorial distributors; rather, it was represented to them that DaMar was "not affiliated" with Gem-Mart. As of December 1983, petitioner was treated as having $5,732.64 invested in the Philip Michaels venture.

Gem-Mart not only offered territorial distributors the above-described programs but also circulated "updates" and "Special Sale Bulletins." These publications were intended to educate territorial distributors about the gemstone industry, to provide information concerning Gem-Mart, and to announce special purchase opportunities and sales programs. Also, they often warned (as indicated above) that, for example, "it is most important that you show some sales activity within your

Territorial Distributorship before the end of the year—in order to have full tax benefits," or "it is this type of purchase which establishes proof of authentic business operation of your Territorial Distributorship for the IRS." In addition, the "Updates" contained a section called "The Late Update" which often discussed tax-related issues such as tax reform, tax collection, and the problem of so-called tax protesters.

Gem-Mart's sales programs were petitioner's only marketing outlet for American Gold's product until March 1983. He then made arrangements with a traveling salesman named Warren Johnson (Johnson) to sell product in Johnson's sales territory, basically North Dakota, Minnesota, and Wisconsin. Petitioner was introduced to the opportunity of selling through a salesman by Dick Koons, who had sold distributorships and who was himself also a territorial distributor in Fargo, North Dakota. Petitioner has never met Johnson.

Petitioner reported the following gross sales from the purchase and sale of American Gold's product:

	Sales by:		
Year	*Gem-Mart*	*Philip Michaels*	*Warren Johnson*
1980	$8,923.00	0	0
1981	[11]74,439.00	0	0
1982	25,851.00	0	0
1983	18,917.71	$2,214.35	$3,193.95

None of these sales occurred in any part of petitioner's assigned territory. Petitioner had no expectation that any individual employed by either Gem-Mart or American Gold would attempt to sell product within his territory.

If the foregoing sales of American Gold's product on petitioner's behalf are to be regarded as having been made pursuant to his Territorial Distributorship Agreement, his purchase of the merchandise involved should have resulted in a reduction in the amounts he owed U.S. Distributor under the notes he used to finance his principal sum payments. Pursuant to paragraph 16 of the agreement, a certain portion of the amounts petitioner owed to U.S. Distributor should have been paid to U.S. Distributor each time purchases of American Gold's product were made by him or on his behalf. Although statements from Gem-Mart indicate that it withheld such payments before crediting petitioner with sales proceeds,[12] the record does not establish that such funds were in fact paid to U.S. Distributor or that, if indeed the payments were made, U.S. Distributor made any notation, either on the notes or otherwise, reflecting such payment.

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[11] Petitioner's only investment with Gem-Mart through 1981 was his original $15,000 check in December 1980. The $74,439 sales, which yielded a "total income" of $7,297 prior to allocating 50 percent thereof to Gem-Mart as its share, obviously were made in substantial part out of a revolving fund based on reinvestments of proceeds of sales stemming from petitioner's original $15,000 investment.

Petitioner elected to use the accrual method of accounting for reporting income and expenses with respect to his territorial distributorship. On Schedule C of his respective Federal individual income tax returns, he reported the following with respect to his alleged operation of the distributorship:

Year	*Total*[13] *income*	*Deductions*	*Net profit or (loss)*
1979	0	$32,100	($32,100)
1980	$992	19,265	(18,273)
1981	7,297	19,745	(12,448)
1982	4,643	2,328	2,315
1983	4,627	1,382	3,245

The deductions in the above table consisted of the following components shown on the respective Schedules of petitioner's returns for the years 1979–83:

1979

Distributorship fee	$32,000
Consulting fee	100
	32,100

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[12] Another confusing aspect of this case that petitioner could not clarify concerns the amount of these withholdings. Documents in evidence indicate that Gem-Mart withheld, as repayments of the notes petitioner used to finance his principal sum payments, amounts ranging from 12½ to 5 percent of petitioner's share of profit on Gem-Mart sales made on his behalf. Petitioner could not "specifically" explain the difference in percentages, but did allude to the changes the modification made to the prepayment obligation. However, these changes (to the extent applicable to petitioner) merely reduced the obligation from 10 percent to 5 percent. Also, although the agreement and the modification require prepayments based upon a percentage of "total cost of TERRITORIAL DISTRIBUTOR for all PRODUCT purchased," Gem-Mart appears to have withheld a smaller amount, based upon a percentage of gross profit, not a percentage of cost.

[13] Total Income = Sales – Cost of Goods Sold + Other Income. The only items of "other income" reflected in the above table were $117 in 1982 identified as "Misc." and $197 in 1983 identified as "Interest."

1980

Bank charges	$80
Commissions	496
Interest	2,620
Office supplies	30
Taxes	39
Distributorship fee	16,000
	19,265

1981

Commissions	3,649
Interest	48
Taxes	9
Distributorship fee	16,000
License	39
	19,745

1982

Bank service charges	3
Commissions	2,264
Taxes	61
	2,328

1983

Bank service charges	32
Commissions	1,297
Taxes	53
	1,382

The "Distributorship Fee[s]" in the amounts of $32,000 for 1979, $16,000 for 1980, and $16,000 for 1981 represent the amounts of the recourse notes petitioner employed in each of those years in making his annual principal sum payments. The 1980 interest deduction of $2,620 equals $1,920 (the 6-percent simple interest with respect to the 1979–$32,000 recourse promissory note), plus $700 (the 10-percent simple interest with respect to the 1979–$7,000 note). Petitioner did not report as income in his 1981 return the 1981 forgiveness of the $1,920 interest component. Nor did he report as income the $700 interest component for any year in which his liability on the $7,000 note may be regarded as terminated. All of the "Commissions" for the years 1980–82 and substantially all of the "Commissions" for 1983 represented Gem-Mart's 50-percent share of the profits on sales which it generated.

On October 6, 1982, petitioner filed Form 5213, "Election to Postpone Determination with Respect to the Presumption that an Activity is Engaged in for Profit," with the Internal Revenue Service Center at Fresno, California. He thus made the election set forth in section 183(e), I.R.C. 1954, to "postpone a determination whether the presumption that an activity * * * is engaged in for profit until the close of * * * the fourth taxable year * * * following the taxable year in which first engaged in such activity." On the Form 5213, he described his "for Profit" activity as the:

> Ownership, operation, development and exploitation of a wholesale and/or retail investment gem and/or jewelry business under the terms of a license and/or territorial distributorship agreement entered into between the taxpayer and his licensor and/or distributor in 1979, or otherwise.

In his deficiency notice herein, dated April 11, 1983, the Commissioner disallowed the losses petitioner claimed on Schedule C of his 1979 and 1980 returns with respect to the operation of his territorial distributorship. The Commissioner explained his determination as follows:

> 1. You have not established that this amount was paid, or if it was paid, that it is an allowable deduction under any section of the Internal Revenue Code of 1954.
>
> 2. You have not established that your activities in your alleged distributorship were not sham transactions to create artificial tax losses.
>
> 3. You have not established that your activities in your alleged distributorship amounted to carrying on any trade or business within the meaning of Section 162 of the Internal Revenue Code of 1954, or were activities within the meaning of Section 212 of the Internal Revenue Code of 1954.
>
> 4. You have not established that your alleged payment of a Distributorship Fee qualifies under Section 1253 of the Internal Revenue Code of 1954.

He further determined that, if the above reasons were not sustained, petitioner's use of the accrual method of accounting materially distorted his income and that, pursuant to section 446(b), I.R.C. 1954, he would be required to utilize the cash receipts and disbursements method of accounting in reporting his income with respect to the operation of the territorial distributorship. Additionally, he determined that the notes used to pay the "Distributorship Fee" were not bona fide debt obligations.

OPINION

This case involves a tax shelter structured as an exclusive territorial franchise to distribute gemstones and items of jewelry in an attempt to take advantage of section 1253(d)(2)(B)(ii) of the Internal Revenue Code of 1954.[14] The principal tax benefit sought under these provisions is the deduction of a "Distributorship Fee" in the amount of "recourse" notes given by the exclusive territorial franchisee as installment payments for his distributorship. In this case, petitioner purported to purchase in 1979 a distributorship for $384,000, payable in 12 annual installments of $32,000 each. The deductions primarily at issue are the face amount of a $32,000 "recourse" note given by him as the first installment in 1979 and the face amount of a $16,000 "recourse" note which he gave as part of the second installment in 1980.[15]

In our judgment, the evidence overwhelmingly establishes that the so-called exclusive territorial franchise involved herein is a sham. We so find as a fact. Accordingly, we hold that petitioner is not entitled to the deductions claimed by him in respect of that exclusive territorial franchise. The mere fact that he may have engaged in random profit-oriented jewelry transactions through Gem-Mart or otherwise in areas wholly outside of his exclusive territory cannot impart bona fides to his "exclusive territorial" franchise allegedly purchased by him. Those transactions were employed in part to give color to petitioner's claim to disproportionately large deductions based upon his alleged obligations relating to his purchase of the exclusive territorial franchise. To be sure, petitioner is entitled to deduct any ordinary and necessary expenses associated with such random sales under section 212 of the Code, and the Government has conceded on brief the allowance of such deductions. But those transactions—to be discussed more fully hereinafter—can hardly justify the allowance of the large deductions of amounts allegedly paid (through notes or interest accrued thereon) in respect of a spurious exclusive territorial franchise itself.

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[14] SEC. 1253. TRANSFERS OF FRANCHISES, TRADEMARKS, AND TRADE NAMES.

(a) GENERAL RULE.—A transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise, trademark, or trade name.

(b) DEFINITIONS.—For purposes of this section—

(1) FRANCHISE.—The term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area.

* * * * * * *

(d) TREATMENT OF PAYMENTS BY TRANSFEREE—

(1) CONTINGENT PAYMENTS.— * * *

(2) OTHER PAYMENTS.—If a transfer of a franchise, trademark, or trade name is not (by reason of the application of subsection (a)) treated as a sale or exchange of a capital asset, any payment not described in paragraph (1) which is made in discharge of a principal sum agreed upon in the transfer agreement shall be allowed as a deduction—

* * * * * * *

(B) in the case of a payment which is one of a series of approximately equal payments made in discharge of such principal sum, which are payable over—

(i) the period of the transfer agreement, or

(ii) a period of more than 10 taxable years, whether ending before or after the end of the period of the transfer agreement,

in the taxable year in which the payment is made * * *

[15] In addition, he gave a $16,000 nonrecourse note to complete the $32,000 installment for 1980. Also related to the franchise is a claimed deduction in 1980 for two items of interest aggregating $2,620 accrued in 1980 in respect of (a) petitioner's $32,000 installment note for 1979 and (b) a $7,000 note given by him as part of a purported obligation to purchase gemstones in 1979.

The record is replete with details leading to our finding that petitioner's exclusive territorial franchise is a sham. It would perhaps serve no useful purpose to enter into a comprehensive discussion of every such detail, but we will now proceed to comment on some of them that we regard as particularly noteworthy.

The sham character of the exclusive territorial franchise.—At the outset, it is important to understand that the very foundation for the entire territorial franchise or distributorship program rested on quicksand. At the base of that program were two newly created entities, American Gold and U.S. Distributor. Neither had any established goodwill or indeed, so far as this record reveals, even any assets of consequence. Although Davis had access to precious gems in substantial amounts, American Gold, itself, had no inventory or product or source of product apart from what Davis might voluntarily make available to it. Yet American Gold purported to grant to U.S. Distributor an exclusive "right" for 50 years to distribute American Gold's "product" worldwide. But, as just noted, American Gold had no "product" other than that which Davis might choose to make available to it, and he was under no contractual or other legal obligation to sell or turn over any "product" to American Gold. Thus, the entire structure could collapse if Davis should decide to direct the flow of the inventory to some other entity controlled by him, or to make some other use of such inventory, or if he should decide to abandon the gemstone and jewelry business, or if he should become incapacitated by accident or illness, or upon his death. And the "right" which American Gold granted to U.S. Distributor was to extend over a period of 50 years—a "right" that was so defeasible and so illusory. The record shows that U.S. Distributor paid absolutely nothing for this "right," and in our view, it wasn't worth much more.

Having paid nothing for the foregoing "right" to distribute American Gold's product worldwide, U.S. Distributor then proceeded to fragment this right into geographical segments and to "sell" such fragments as exclusive territorial distributorships to franchisees, each of whom would then theoretically undertake to promote the sale of American Gold's product within the exclusive specified territory allocated to him. The minimum price for such a franchise or distributorship was $240,000, an amount that increased sharply depending primarily upon the amount of "tax savings" that the purchaser wished to achieve. Petitioner chose to purchase one for $384,000. The goal of the program was to sell some 5,000 distributorships, although only about 1,000 were actually sold. Even at the minimum price of $240,000, the total amount thus sold was at least about $240 million—all for segments of a "right" which U.S. Distributor got for nothing and which was wholly illusory! In this connection, the territorial distributorship program is not unlike other so-called tax shelters which involve the resale of, for example, motion pictures, master recordings, or lithographic plates, at grossly inflated prices. See, e.g., *Flowers v. Commissioner*, 80 T.C. 914, 937 (1983); *Siegel v. Commissioner*, 78 T.C. 659, 685 (1982); *Brannen v. Commissioner*, 78 T.C. 471, 494, 498 (1982), affd. 772 F.2d 695 (11th Cir. 1984); *Reali v. Commissioner*, T.C. Memo. 1984-427, 48 T.C.M. 826, 53 P-H Memo T.C. par. 84,427. See also *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1048 (9th Cir. 1976), affg. 64 T.C. 752 (1975); *Estate of Baron v. Commissioner*, 83 T.C. 542, 554 (1984).

Bearing in mind that neither American Gold nor U.S. Distributor had any goodwill whatever in respect of any potential exploitation of that "right," one may well ask who in his right mind would undertake to buy a $240,000 or $384,000 franchise in these circumstances. In the case of petitioner, whom we found to be knowledgeable and highly sophisticated, the answer surely cannot be found in the oft-repeated cynical observation attributed to P.T. Barnum that "There's a sucker born every minute." The explanation is that the entire program of exclusive territorial franchises was merely an elaborate scheme to avoid taxes, having no business purpose.

The inescapable conclusion is that the so-called exclusive territorial franchise involved herein is a sham, and that it is not the sort of thing that Congress ever intended to include within the meaning of "franchise" in section 1253, any more than it intended the virtually meaningless steps in *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), to qualify as a corporate "reorganization" within the statutory provisions there under consideration. In the numerous attempts to support tax-avoidance devices, it has become increasingly fashionable to quote dicta in *Gregory* to the effect that a taxpayer has the legal right "to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits" (293 U.S. at 469). But the use of that dicta in cases like the present stands *Gregory* on its head, for the very holding in *Gregory* was to the contrary, where the Court concluded that what was done there, even though scrupulously in accord with the literal language of the statute, was mere artifice and not the thing that the statute intended. In this connection, compare *Saviano v. Commissioner*, 765 F.2d 643, 654 (7th Cir. 1985), affg. 80 T.C. 955 (1983), where the Seventh Circuit stated in commenting upon the principle that one may so arrange his affairs that his taxes may be as low as possible:

> The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, and in fact duty-bound, to look beyond the contrived forms of transactions to their economic substance and to apply the tax laws accordingly.

The fact that petitioner did actually participate in some profit-oriented jewelry transactions wholly unrelated to his exclusive territory should not obscure the spurious nature of the franchise itself. Before commenting more fully on this aspect of the case, we will meanwhile now set forth some of the factors relating to petitioner's Territorial Distributorship Agreement, itself, and the conduct of the parties thereunder, which give further confirmation to our findings as to the sham character of his exclusive territorial franchise.

Although petitioner purported to undertake to pay $384,000 for an exclusive territorial distributorship, his exclusive territory was nowhere identified in the agreement, either when signed by him on December 27, 1979, or when signed on behalf of the other parties thereto on February 29, 1980. The only place in the agreement where the territory was to be specified was Exhibit D. But Exhibit D was left entirely blank when the agreement was originally signed by petitioner in December 1979 and finally executed by all parties in February 1980. To be sure, petitioner had requested a territory including certain portions of Encino, California, and Bethesda, Maryland, and he had been told by a Mr. Knowles in December 1979 that such territory would be assigned to him if it had not been assigned to someone else. But such oral "assurance" by Mr. Knowles had no binding effect, and in fact no such assignment was made to petitioner on February 29, 1980, when the agreement was finally executed by all the parties.

It staggers the imagination to believe that any careful lawyer like petitioner would even consider obligating himself to purchase an exclusive territorial franchise for $384,000—an amount shown by the evidence to have been vastly in excess of any investment that he had ever theretofore made in his lifetime—when the location of the territory was not specified in the contract. Indeed, under the contract, he could have been assigned a territory in Alaska, in the Soviet Union, in Greece, Turkey, South Africa, Sri Lanka, or anywhere in the world. The location of the territory does not appear to have been of critical importance to petitioner, and the real explanation for this seemingly extraordinary situation is that this was no true, bona fide agreement to purchase an exclusive territorial franchise.

We note that a completed Exhibit D was received by petitioner in August 1980, but even this Exhibit D was superseded by another Exhibit D in October 1980, specifying different areas identified by different zip code numbers in both Encino and Bethesda. It was explained to him that some unidentified person named "Penni" had been assigning territories incorrectly. Again, this is but further evidence that the parties were not taking the agreement seriously, and gives added weight to our finding of sham.

Another fact that we cannot ignore is that, up to the time of trial herein (July 1984), petitioner never made any sales whatever, or attempted to make any sales, or even explored the possibility of making any sales in his exclusive territory—either in person, or through Gem-Mart or any other agent. He explained his failure to make any effort on the ground that beginning sometime in 1980 there was a sharp decline in selling prices of investment-grade diamonds, that the diamond market was in disarray, and that he was waiting for it to stabilize. We found that explanation wholly unconvincing and incredible.

True, the evidence did establish that there had been a very steep and uncontrolled rise in the sales prices of investment-grade diamonds for a period up to some point in 1980, when there was a turnaround in prices for such stones. However, we regard the evidence in respect of the diamond market merely as a smokescreen, calculated to mislead the IRS and this Court. Investment-grade diamonds represented only a part of American Gold's purported "product," and, as indicated by the minimum product requirement of the agreement, the real focus was not upon investment-grade diamonds but upon the high-profit imported colored gems, products C and D. Petitioner could readily have undertaken (either alone or through an agent) to do something about making sales or at least exploring the possibility of making sales of colored gems or other product in his exclusive territory. Plainly, he was not limited to selling investment-grade diamonds, and the record shows that there was market activity even in sales of diamonds, generally. Indeed, in December 1980, Gem-Mart sold some diamonds on petitioner's behalf in a random sale or sales wholly unrelated to his exclusive territory. We simply do not believe petitioner's explanation for his failure to make any effort whatever, even on an exploratory basis, to visit a single jewelry outlet in his territory. The real explanation is that he "bought" a tax-avoidance device, not a bona fide $384,000 exclusive territorial franchise.

Further evidence of the spurious character of the agreement is the conduct of the parties in respect of the contractual requirement that petitioner purchase "Minimum Product" for cash. His obligation in this respect was to buy for cash minimum product in an amount equal to one-fourth of the face amount of any recourse note given by him as part of an installment payment of the purchase price of his franchise. Since he gave such notes in the amounts of $32,000, $16,000, and $16,000 for the years 1979, 1980, and 1981, respectively, he was contractually obligated to buy minimum product for cash in the amounts of $8,000, $4,000, and $4,000, for those years, respectively. Yet, he did no such thing, with the assent of, or at least without objection from, any of the parties concerned. He purchased $1,000 of minimum product (imported colored stones) in 1979, and nothing in 1980 or 1981. Instead, he gave notes (for which he did not receive any minimum product) in the amounts of $7,000, $4,000, and $4,000. These notes have not been paid. He has been explicitly relieved of liability on one of them, and, in our view of the evidence, he neither regards himself as liable on the other two, nor will he ever make payment thereon.

In 1981, there was a "Modification" agreement which made substantial changes in petitioner's original agreement to purchase his $384,000 exclusive territorial franchise. The Modification Agreement was undated, and recited merely that it "has been executed no later than December 31, 1981," an extraordinary situation leaving up in the air the matter of just when the revised provisions became legally effective.[16] Notwithstanding some testimony indicating otherwise, we are satisfied on the record that there were no real negotiations between the parties as to the substance of the Modification Agreement. These new provisions were characterized by confusion, sloppy draftsmanship, and inaccuracies—hardly the sort of thing that a competent lawyer like petitioner would have been expected to enter into if it were indeed regarded seriously by the parties as fixing their respective rights and obligations.

One of the most amazing provisions in the modification agreement is a retroactive elimination of interest on installment notes given in payment of the principal sum ($384,000). Since the notes bore 6-percent simple interest and matured some 25 to 30 years later, the elimination of the interest reduced petitioner's purported ultimate aggregate liability by over 150 percent of the face amounts of the notes. Moreover, as we pointed out in our findings, *supra*, p. 90, the self-contradictory language in one of the notes identified as a nonrecourse note described the maker's liability as unlimited! Petitioner obviously paid little, if any, attention to the content of these notes when he signed them.

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[16] The parties stipulated that "In approximately September 1981, petitioner executed" the Modification Agreement. There is no evidence whatever as to when it was executed by the other parties or as to the date when it became legally binding upon the parties.

Of even greater significance in assessing the bona fides of the entire transaction is petitioner's indifference to obtaining possession of the old notes when executing new, substitute notes under the Modification Agreement. It is inconceivable to us that a knowledgeable and careful lawyer like petitioner would execute a new note without, at the same time, having the substituted note returned to him, particularly when he regarded them as being possibly negotiable. The record indicates that he did not even make any effort to recover possession of the old notes. The explanation in our judgment is that he did not take these notes seriously and that he did not think that he would ever be called upon to pay them. We heard his testimony that he intended to pay those notes ultimately, but we did not find that testimony credible. In the context of this entire record, we do not believe that petitioner in fact contemplates payment of the notes.[17] This circumstance gives added weight to our finding that his exclusive territorial franchise is a sham.

In reaching the foregoing conclusion as to the nature of petitioner's "exclusive territorial franchise," we hasten to point out that we were fully aware of, but not fooled by, petitioner's transparent attempts to clothe his distributorship in the garments of a genuine business enterprise. The adoption of the fictitious name "Euhedral Enterprises," the registration of that name with the Los Angeles authorities, the Los Angeles authorization of Euhedral to make retail and wholesale sales, the obtaining of a seller's permit from the California State Board of Equalization, the purchase of stationery and business cards bearing Euhedral's name, the opening of checking accounts in its name in California and North Dakota, the payment of minor amounts of business taxes to the City of Los Angeles during the years 1980–84, the filing of sales tax returns with the California Board of Equalization during 1981–83 (unaccompanied by any payment, since there were no California sales)—all these were merely parts of the disguise obviously intended to project the misleading image of a gemstone business being carried on by petitioner in his exclusive territory. Petitioner never conducted any gemstone or jewelry business, either alone or through Gem-Mart or any other agent, in his exclusive territory. The adoption of the name Euhedral Enterprises was nothing more than a meaningless gesture. There is not the slightest indication that there was any advertising in its name, or that there were any efforts whatever, by mail, word of mouth, or otherwise, to call attention to its very existence to any prospective purchaser of gems.

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[17] Nor is our conclusion in this respect affected by the provisions of par. 16 of the agreement, *supra*, p. 80, requiring prepayments in the amount of 10 percent of the franchisee's cost for all product (other than minimum product) purchased from American Gold. In the first place, no product was purchased by petitioner for resale in his exclusive territory. Moreover, to the extent that Gem-Mart acquired any product on petitioner's behalf, which it sold in random transactions outside of petitioner's territory, it withheld from him a percentage of the profit on sale, not the larger amount based upon a percentage of cost as purportedly required by par. 16 of the agreement. Such withholdings appear to have been in comparatively small amounts. Further, the record is utterly silent as to whether the amounts of any such withholdings were ever recorded on the notes as having been paid to that extent. Since petitioner thought that the notes might be negotiable, it again raises the troubling question whether he seriously regarded them as an obligation, particularly in view of the fact that he made no effort to find out whether such "prepayments" had actually been entered on the notes. The entire subject of the so-called prepayments impresses us merely as a device for increasing to some extent the profits realized on behalf of the owners of American Gold and U.S. Distributor (both ultimately owned in identical proportion by the same persons) on the random sales of gems furnished to the program by Davis—in part as part of an attempt to give color to the purported bona fides of the exclusive territorial franchise.

The record is replete with other evidence of lack of bona fides in petitioner's purported purchase of an exclusive territorial franchise for $384,000. We need not belabor the point further. The exclusive territorial franchise was a sham. Section 1253 was never intended to apply to any such situation. And the same considerations are equally applicable to any attempt to support the claimed deductions under section 162 to the extent that they relate to the so-called exclusive territorial franchise. Petitioner is therefore not entitled to any deduction for accrued distributor's fees or interest in respect of any note relating to the exclusive territorial franchise.

There is a further aspect to this case which, in any event, calls for the disallowance of the deduction claimed by petitioner for 1979. As is amply revealed by the record and set forth in our findings, there was no binding contract whatever during 1979 giving petitioner any purported franchise. The earliest date on which any contract was executed by the parties was February 29, 1980, and even on that date no exclusive territory was then assigned to petitioner.

The jewelry transactions conducted or arranged by Gem-Mart.—Although it is true that petitioner invested certain funds to enable Gem-Mart to execute some jewelry transactions, either directly on petitioner's behalf or through a joint venture, these transactions bore no relationship whatever to petitioner's so-called exclusive territorial franchise. Not a single sale was made—or even attempted to be made so far as this record discloses—in the exclusive territory[18] allegedly purchased by petitioner for $384,000. These sales had nothing whatever to do with petitioner's so-called exclusive territory. Yet the principal deductions at issue herein are amounts euphemistically described as "distributorship fees," purportedly paid or incurred by petitioner to acquire his exclusive territorial franchise.

To be sure, the sales made by Gem-Mart either directly or through Philip Michaels in Denver, Colorado, can fairly be treated as transactions entered into for profit. And the Government now concedes that petitioner is entitled under section 212 to all the ordinary and necessary expenses incurred in connection with these sales. But the spurious "distributorship fees" do not qualify as such ordinary and necessary expenses. Such "fees" were in no sense proximately related to these sales. The "fees" were theoretically incurred to obtain an exclusive territorial franchise, and these sales were not made in any way in connection with any such exclusive territorial franchise. Such sales were obviously calculated in part to create the misleading impression that petitioner had made a bona fide purchase of an exclusive territorial franchise and was actually making sales pursuant to the authority granted to him under that franchise. No such latter conclusion could be further from the truth.

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[18] We note also that par. 25(c) of the Territorial Distributorship Agreement, *supra*, pp. 80–81, recites that petitioner "intends to personally promote the PRODUCT *in the Territory* acquired or cause promotion to be effected *within the Territory*" (emphasis supplied). The evidence establishes that there was no compliance herein with this provision.

Nor is there any persuasive force to petitioner's desperate effort to breathe vitality into his position by the suggestion that the sales made outside his territory were made "on an exclusive basis, together with other distributors," which should therefore qualify for treatment under section 1253. He contends that more than one person can join in the acquisition of an exclusive right to distribute a product. This is an unassailable truism, but that is not what occurred here. Petitioner did not join with anyone in "acquiring" his "exclusive territorial franchise," nor did he join with anyone else in acquiring exclusive rights to distribute American Gold's product in the territory of such other person. It is sheer nonsense to assert that sales made by the joint venture were made in any exclusive territory acquired by petitioner.[19] These sales were nothing more than transactions entered into by petitioner for profit—whether regarded as casual transactions governed by section 212 or as a separate business governed by section 162—wholly unrelated to any exclusive territorial franchise allegedly purchased by him. He is entitled to no deduction under section 1253 or under section 162 in respect of any exclusive territorial distributorship fee or any item relating thereto. He is entitled under section 212—and possibly under section 162—to any ordinary and necessary expenses incurred in connection with such sales, but such expenses do not include any "distributorship fee" or any item relating thereto.

What we have said above is applicable in large part to the few sales made on petitioner's behalf in 1983 by the traveling salesman, Warren Johnson. These sales were made in Johnson's area of business activity, namely, North Dakota, Minnesota, and Wisconsin. They were wholly unrelated to any exclusive territorial franchise allegedly purchased by petitioner for zip code areas belatedly specified in Encino, California;

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[19] Further, in this connection, the first sentence of par. 25(d) of the Territorial Distributorship Agreement provides that "as a TERRITORIAL DISTRIBUTOR, [petitioner] will not be entitled to participate with other TERRITORIAL DISTRIBUTORS with reference to expenses, profits, or otherwise." Moreover, the second sentence of that paragraph states that the territorial distributor's "profits, if any, earned as a TERRITORIAL DISTRIBUTOR will depend solely on his own management and marketing ability, and not that of the DISTRIBUTOR or the IMPORTER or any affiliate." Yet Gem-Mart was wholly owned by American Gold (the "Importer"), and petitioner's contract with Gem-Mart, pursuant to which Gem-Mart conducted or arranged to conduct all of the sales in 1980, 1981, and 1982, on petitioner's behalf, was entered into on Feb. 29, 1980, the very same day that the Territorial Distributorship Agreement was entered into by all the parties thereto.

Bethesda, Maryland; and Galway and Waterford, Ireland. Such sales in no way support petitioner's claim to deductions for his exclusive territorial "distributorship fees" and related items.

Burden of proof and other issues.—At the start of the trial, petitioner filed a "Motion to Shift Burden of Proof to Respondent Re the Issue of Whether Petitioner Engaged in the Activity at Issue Herein for Profit." Since petitioner's counsel assured the Court that a ruling on the motion would not affect his conduct of the case, and since he recognized that the sham issue raised by the Government "probably covers the profit motive material also," the Court decided not to rule on the motion at that time. The motion was based upon section 183 of the Code, pertinent provisions of which are set forth in the margin.[20] Petitioner relies upon the alleged fact that he reported a profit in 2 of 5 consecutive years as required by section 183(d) and the fact that he timely filed an election under section 183(e). Petitioner's position is explained in his motion as follows:

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[20] SEC. 183. ACTIVITIES NOT ENGAGED IN FOR PROFIT.

(a) GENERAL RULE.—In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

(b) DEDUCTIONS ALLOWABLE.—In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) ACTIVITY NOT ENGAGED IN FOR PROFIT DEFINED.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

(d) PRESUMPTION.—If the gross income derived from an activity for 2 or more of the taxable years in the period of 5 consecutive taxable years which ends with the taxable year exceeds the deductions attributable to such activity (determined without regard to whether or not such activity is engaged in for profit), then, unless the Secretary establishes to the contrary, such activity shall be presumed for purposes of this chapter for such taxable year to be an activity engaged in for profit. In the case of an activity which consists in major part of the breeding, training, showing, or racing of horses, the preceding sentence shall be applied by substituting the period of 7 consecutive taxable years for the period of 5 consecutive taxable years.

(e) SPECIAL RULE.—

(1) IN GENERAL.—A determination as to whether the presumption provided by subsection (d) applies with respect to any activity shall, if the taxpayer so elects, not be made before the close of the fourth taxable year (sixth taxable year, in the case of an activity described in the last sentence of such subsection) following the taxable year in which the taxpayer first engages in the activity. For purposes of the preceding sentence, a taxpayer shall be treated as not having engaged in any activity during any taxable year beginning before January 1, 1970.

(2) INITIAL PERIOD.—If the taxpayer makes an election under paragraph (1), the presumption provided by subsection (d) shall apply to each taxable year in the 5-taxable year (or 7-taxable year) period beginning with the taxable year in which the taxpayer first engages in the activity, if the gross income derived from the activity for 2 or more of the taxable years in such period exceeds the deductions attributable to the activity (determined without regard to whether or not the activity is engaged in for profit).

> Internal Revenue Code Section 183(d) provides that should the taxpayer so elect, respondent may not make a determination as to whether the presumption applies. Petitioner properly made the election. Since the determination in the Statutory Notice of Deficiency was premature, it should have been raised only by way of respondent's Answer. In this regard, Rule 142(a) of the Rules of Practice and Procedure of the United States Tax Court states, in relevant part, "The burden of proof shall be upon the petitioner, * * * except that in any new matter * * * pleaded in his answer, it shall be upon respondent * * *."

We reject that contention. It is faulty for a number of reasons, but we need articulate only several of them. In the first place, regardless of who bore the burden of proof, a full record was made herein, and our conclusion as to the sham character of the exclusive territorial franchise is amply supported by the evidence even if the burden of proof was upon respondent.

In the second place, petitioner's position is based upon the slippery assumption that his concededly bona fide casual jewelry transactions may be blended together with a phony exclusive territorial franchise so as to create the illusion of a single "activity" within section 183, in order to support the deduction of a spurious "distributorship fee" by reson of profits earned in two years from the casual jewelry transactions. But, as we have found above, these two "activities" may not be synthesized. In fact, petitioner carried on no "activity" whatever in respect of his purportedly exclusive territorial franchise.[21] The casual sales bore no valid relationship whatever to the so-called exclusive territorial franchise, and there was no profit whatever in any of the 5 years in respect of the "activity" of functioning as *a territorial distributor*.

Before petitioner may successfully invoke the provisions of section 183(d) and (e), the burden is upon him to show that he qualifies thereunder, i.e., that the conditions specified for the application of these provisions have been met. As with any presumption, the party relying upon it must establish the basic facts giving rise to it. Fed. R. Evid. 301 advisory committee note.[22] See also S. Rept. 93–277, at 9 (1974); H. Rept. 93–1597, at 5–6 (1974). In this connection, petitioner has totally failed. He has not shown that there was an "activity" over a 5-year period in which the alleged exclusive territorial franchise was an integral part, and in which he derived a profit in 2 of the 5 years. To the contrary, the record is abundantly clear in revealing that whatever jewelry transactions may have been conducted on petitioner's behalf, none of them could properly be blended with the exclusive territorial franchise so as to represent a single "activity" in which the distributor's fees are a legitimate charge against the profits of the jewelry sales. The same considerations that we dealt with earlier in this opinion in support of our finding that the so-called exclusive territorial franchise was a sham are equally pertinent here.

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[21] We note that in connection with the "at risk" provisions of sec. 465, there may be instances where some activities may be "aggregated." Sec. 465(c)(3)(B) and (C). But even under those provisions, petitioner's inactive "activity" of being an exclusive territorial distributor could not be aggregated with his wholly separate "activity" involving random sales of jewelry elsewhere.

A further impediment may well exist in respect of petitioner's position. The statutory provisions involve not a burden of proof, but merely a *presumption*. Once established, a presumption requires only that the party against whom it is directed go forward with evidence to rebut or meet the presumption. The "risk of nonpersuasion"—i.e., the burden of proof—remains throughout the trial on the party on whom it was originally cast. Fed. R. Evid. 301. See *Rockwell v. Commissioner*, 512 F.2d 882, 885 (9th Cir. 1975). But see *Faulconer v. Commissioner*, 748 F.2d 890 (4th Cir. 1984), reversing a memorandum opinion of this Court. However, we need not pass upon this point.

Moreover, in view of the conclusion that we have reached, we need not dwell on still further considerations that arguably support the Government's position—e.g., that even the modest "profits" reported by petitioner for the two years 1982 and 1983 would vanish if the nonrecourse notes in those years were taken into account; that in view of the possibility of distortion of income by manipulative use of recourse or nonrecourse notes to produce either profit or loss under the accrual system, the Commissioner was justified in requiring petitioner to report his transactions on the cash basis rather than on the accrual basis in order to clearly reflect his income, thereby resulting in the disallowance of the deduction for the distributor's fees reflected in the unpaid "recourse" notes given in 1979 and 1980, the years before the Court; or that regardless of petitioner's system of accounting, section 1253(d)(2)(B) requires actual "payment" in discharge of the principal sum over a period of 10 or more years and that petitioner's recourse notes "are merely promises to pay, rather than payments." Cf. *Don E. Williams Co. v. Commissioner*, 429 U.S. 569 (1977).

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[22] Trials before this Court are conducted in accordance with the Federal Rules of Evidence, 28 U.S.C. app., the rules of evidence applicable in trials without jury in the U.S. District Court for the District of Columbia. Sec. 7453, I.R.C. 1954; Rule 143(a), Tax Court Rules of Practice and Procedure; Fed. R. Evid. 101.

It is not necessary to pursue the matter any further. The claimed deductions now in controversy were plainly not allowable.

Decision will be entered for the respondent.

BUDGET FILMS, INC., A CALIFORNIA CORPORATION, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 7342–81. Filed July 29, 1985.

P rented films to the general public. P acquired a film for rental in the United States that was or may have been shown in Mexico. *Held*, the film is not new sec. 38 property. *Fife v. Commissioner*, 82 T.C. 1, 15 (1984), followed.

P also compiled for rental, reels of film composed of individual film segments previously exhibited publicly, although in a different format. The segments (cartoons and short subjects, musical variety entertainment, and other footage) were spliced together and compiled and distributed as packages. *Held*, these modifications, without more, do not create "reconstructed films."

P acquired footage of Spanish bullfights which it edited into a 30-minute film entitled, "Bullfights from Spain." P also acquired, edited, and distributed under various titles several films of live Beatles concerts. None of these films had been previously distributed. *Held*, these films are not "primarily topical" or "essentially transitory" and are qualified films. Cf. *Goodson-Todman Enterprises, Ltd. v. Commissioner*, 84 T.C. 255 (1985), on appeal (2d Cir., May 31, 1985), and *Cosby v. United States*, 8 Cl. Ct. 428 (1985).

Marcus Kalb, for the petitioner.
Karen J. Simonson, for the respondent.

WILBUR, *Judge*: Respondent determined deficiencies of $5,949 in petitioner's Federal income taxes for the taxable year ended April 30, 1977, and of $9,240 for the taxable year ended April 30, 1978.

After concessions by both parties, the issue for decision is whether petitioner is entitled to claim the investment tax credit under section 48(k)[1] with respect to various motion picture films. Specifically, we must address the following issues:

(1) Whether the films constitute "new section 38 property";

(2) Whether the films are "qualified films"; that is, whether they were created "primarily for use as public entertainment or for educational purposes," and do not have markets that are "primarily topical" or "otherwise essentially transitory in nature"; and

(3) Whether, at best, petitioner is entitled to only two-thirds of the claimed credit because it failed to make a proper election under section 48(k)(3).

FINDINGS OF FACT

The parties submitted a detailed stipulation of facts, and those facts are so found. The stipulation of facts and attached exhibits are incorporated by this reference.

Budget Films, Inc., is a corporation organized under the laws of California. Its principal place of business was in Los Angeles, California, when the petition was filed in this case. Petitioner timely filed Federal corporate income tax returns for the taxable years ended April 30, 1977, and April 30, 1978.

Petitioner was in the business of renting films to the general public during the years in issue. Its customers included individuals, colleges, religious institutions, shipping lines, movie studios, and production companies. The customers usually ordered films through Budget Films catalogs. Budget Films generally prohibited its customers from renting films for "theatrical" purposes; that is, the customers were not generally entitled to charge admission to audiences, and they were not permitted to show the films on television.

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[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect during the years in issue, unless otherwise indicated, and any reference to Rules refers to the Tax Court Rules of Practice and Procedure.

Budget Films spent $57,878 in the taxable year ended April 30, 1977, and $86,050 in the taxable year ended April 30, 1978, in order to acquire prints and negatives of films. Approximately $35,885 of the $57,878 paid by petitioner for film prints and negatives during the taxable year ended April 30, 1977, was paid for prints of films that had been shown to the public before petitioner acquired them. Likewise, approximately $36,544 of the $86,050 petitioner paid to acquire film prints and negatives during the taxable year ended April 30, 1978, was paid for prints of films that had been shown to the public before petitioner acquired them.

The following films were new and had not been released to the public in any format before petitioner acquired them and placed them in service: "The End," "Story Theatre No. 7," "Story Theatre No. 11," "Story Theatre No. 15," "Story Theatre No. 19," "Story Theatre No. 23," "Marvin," and "Spaghetti Western." "The End" and the "Story Theatre" group of films were acquired for $4,080 in the taxable year ended April 30, 1977. "Marvin" and "Spaghetti Western" were acquired for $2,300 in the taxable year ended April 30, 1978. Petitioner asserts that it is entitled to claim a tax credit of 10 percent of the amount it paid to acquire the films, or $408 for 1977, and $230 for 1978. Respondent asserts that only two-thirds of these amounts, or $272 for 1977 and $153 for 1978, are allowable as tax credits.

The above films were not the only films released by Budget Films for the first time. In addition, in the taxable year ended April 30, 1977, petitioner acquired footage of Spanish bullfights which it edited into a 30-minute film entitled "Bullfights from Spain." Petitioner paid $2,250.98 to acquire the film, edit it, create a negative, and make prints. The footage had not been released before petitioner distributed it. Moreover, in the taxable year ended April 30, 1978, Budget Films acquired, for $5,121.75, several films of live Beatles concerts. Petitioner arranged to edit some of the films, and distributed them with the titles "Around the Beatles," "Beatles at Shea Stadium," "Beatles Concert in Tokyo," and "Beatles Concert in Washington, D.C." The films were made by amateurs and had not been distributed before petitioner acquired them.

Petitioner also acquired a rare nitrate print of Rudolfo Goana, a famous Mexican bullfighter. A fee of $1,800 was paid to acquire the print, edit and restore it, and make a negative and prints. Although the film may have been released in Mexico before petitioner acquired it, it was never released in the United States.

All of the films described below were composed entirely of individual segments of film that had been or may have been exhibited to the public before petitioner acquired them. Petitioner generally made longer films by connecting several of the film segments and sometimes by editing the longer film reel. The following films were composed of groups of cartoons or short subjects:

	Acquisition cost	
Name of film	*Apr. 30, 1977*	*Apr. 30, 1978*
"30 Color Cartoon Programs"	$3,600	- - -
"Variety Programs #1-10"	1,000	- - -
"Warner Brothers Color Cartoon Programs #1-5"	500	- - -
"Mighty Mouse Color Cartoon Packages #1-4"	400	- - -
"Terrytoon Color Cartoon Packages #1-4"	400	- - -
"Spook Spectacular Programs, Shows #1-4"	850	- - -
"30 Color Cartoon Programs"	- - -	$3,600
"Variety Programs #11-20"	- - -	1,000
"Warner Brothers Color Cartoon Programs #6-10"	- - -	500
"Mighty Mouse Color Cartoon Packages #5-8"	- - -	400
"Terrytoon Color Cartoon Packages #5-8"	- - -	400
"Spook Spectacular Programs, Shows #7-12"	- - -	850
Total	6,750	6,750

Petitioner arranged to splice two or three cartoon or short subjects together and distributed them as reels of two or three, but otherwise did not edit the films in any way. The films had been released in other media, on television or in movie theaters, but they had been released individually, and not in the format in which petitioner distributed them.

The following films were acquired as individual newsreels, serials, trailers, and footage of sporting events, and were packaged by petitioner in groups. Petitioner arranged to splice the footage together and paid for other miscellaneous editing involved in preparing the final reels. Petitioner also paid for prints which were distributed as films ranging from 10 minutes to feature length. Petitioner does not know whether the individual newsreels and other footage had been exhibited to the public prior to being assembled in their current format. They had not been released previously in the format in which petitioner released them.

Name of film	Acquisition cost Apr. 30, 1977	Acquisition cost Apr. 30, 1978
"Vintage Sports Reels #1–10" (newsreels and sports footage)	$1,500	- - -
"Old Time News Reels #1–4, Nickelodeon Theater #1–2" (newsreels and comedy shorts)	2,500	- - -
"Purple Death, Three Musketeers, Phantom Creeps, Hurricane Express, Lost City" (serials)	- - -	$7,600
"Camps of the Dead, Auto Racing, Dangerous Wheels and Rudders, Holocaust, In Famous [sic] Age of Crime, From Dunkirk to Hiroshima, Disasters of 30's, Terror of the Third Reich, Riots and Rebellions, Spectacular Disasters" (newsreels)	- - -	10,500
"Variety Boxing Reels #1–10" (newsreels; sports footage)	- - -	2,475
"Crime Does Not Pay" (newsreels)	- - -	850
"World War II: A History" (newsreels)	- - -	900
"British Trailer Reel, Black Preview Trailer Reel, Elvis Trailer Reel, Movie Trailer Reels #1 and 2" (trailers)	- - -	2,125
Total	4,000	24,450

The following films were composed of several short subjects of musical variety entertainment, most of which had been released previously as "soundies."[2] These films were acquired in the taxable year ended April 30, 1978, and were compiled and distributed as packages. They had not been released as packages previously.

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[2] A film released in "soundie" format can be viewed only by looking into a machine.

Name of film	*Acquisition cost*
"Sepia Stars on Parade, Shows #1-4"	$850
"Turn Out the Lights, Gale Storm Sings, Jon and Sandra Steele Sing, Polka Dot Polka, Sarah Vaughn Sings, Sepian Swing, Musical Satires"	2,000

The following films, acquired during the taxable year ended April 30, 1977, were composed of parts of some very old French and American films which petitioner edited into 10- or 20-minute reels and first released in new format in the taxable year ended April 30, 1978: "Best of the Melies," "Fantastic Films," "Films by Three French Pioneers," "Early French Comedies," "Emil Cohl Films," "Emil Cohl-Jean Durand," "Animation No. 1," and "Moments from 'Birth of a Nation.' " The cost of purchasing the old films, having them edited, and having new negatives and prints created was $6,234.34. "Birth of a Nation" had been released before petitioner acquired it. Petitioner does not know whether the other films in this category had been released previously. None of the films had been released previously in the format in which petitioner released them.

In the taxable year ended April 30, 1977, petitioner acquired several 16 millimeter Charlie Chaplin "Kodascope" prints that had been distributed by Eastman Kodak in the 1930's. Petitioner arranged to splice together three 80-minute reels, each consisting of four 20-minute short subjects. The total cost was $4,922. The short subjects had been released before petitioner acquired them but had never been released in the format in which petitioner distributed them. Petitioner called the films "Charlie Chaplin Cavalcade," "Charlie Chaplin Festival," and "Charlie Chaplin Carnival."

The remainder of the expenditures at issue (approximately half of the total expenditures for which the investment tax credit was claimed) were made with respect to films that had been released previously and were not altered in any way by petitioner.

OPINION

We must decide whether the investment tax credit is available for each of petitioner's films. To claim the investment credit for movie and television films pursuant to section 48(k),[3] the taxpayer must show that three requirements have been met: (1) The film must be "new section 38 property," (2) the film must be "qualified," and (3) the taxpayer must have an "ownership interest" in the film. The first two requirements are at issue in this case.

Issue 1. New Section 38 Property

"Section 38 property" means, among other things, tangible personal property with respect to which depreciation is allowable. Sec. 48(a). "New section 38 property" is defined in section 48(b) as section 38 property—

> (1) the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or
>
> (2) acquired after December 31, 1961, if the original use of such property commences with the taxpayer and commences after such date.

Property is considered to have been constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. Sec. 1.48–2(b)(1), Income Tax Regs. The term "original use" means "the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer." Sec. 1.48–2(b)(7), Income Tax Regs.

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[3] Sec. 48(k) provides as follows:

> SEC. 48(k). MOVIE AND TELEVISION FILMS.—
>
> (1) ENTITLEMENT TO CREDIT.—
>
> (A) IN GENERAL.—A credit shall be allowable under section 38 to a taxpayer with respect to any motion picture film or video tape—
>
> (i) only if such film or tape is new section 38 property (determined without regard to useful life) which is a qualified film, and
>
> (ii) only to the extent that the taxpayer has an ownership interest in such film or tape.
>
> (B) QUALIFIED FILM DEFINED.—For purposes of this subsection, the term "qualified film" means any motion picture film or video tape created primarily for use as public entertainment or for educational purposes. Such term does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature.
>
> (C) OWNERSHIP INTEREST.—For purposes of this subsection, a person's "ownership interest" in a qualified film shall be determined on the basis of his proportionate share of any loss which may be incurred with respect to the production costs of such film.

We must decide whether the investment tax credit is available for four general categories of films: (1) Films that had been exhibited to the public before petitioner acquired them, and that petitioner did not alter in any way, (2) films that had never been exhibited to the public before petitioner acquired them, (3) a film that may have been exhibited in Mexico, but was not exhibited in the United States before petitioner acquired and released it unaltered, and (4) films composed of a group of individual film segments that had been or may have been exhibited to the public previously.

The films in the first category (previously exhibited and unaltered) clearly do not constitute new section 38 property because they were "acquired" and were first released by someone other than petitioner. Indeed, petitioner did not even address this category of films on brief. On the other hand, the films in the second category (never exhibited prior to petitioner's acquisition) clearly do constitute new section 38 property, and respondent concedes as much. The only real questions relating to "new section 38 property" arise in connection with the third and fourth categories of films.

The third category consists of a film that may have been exhibited in Mexico, but had not been exhibited in the United States before petitioner acquired it. Since petitioner stipulated that it "does not know" whether the film was released in Mexico, it has not satisfied its burden of proof or its burden of coming forward with evidence to rebut the presumption of correctness relating to the notice of deficiency. We thus must proceed on the presumption that the film had been exhibited to the public in Mexico. Rule 142(a); *Welch v. Helvering*, 290 U.S. 111 (1933).

Section 1.48–8(a)(2), Income Tax Regs., provides that:

> Once a qualified film is placed in service in any medium of exhibition in any geographical area of the world, it becomes used property and no investment credit with respect to the film is available to a taxpayer that acquires the film after that time (except for subsequently incurred costs described in paragraph (e)(9) of this section which the taxpayer incurs). * * *

This Court recently stated in *Fife v. Commissioner*, 82 T.C. 1, 15 (1984), that "section 1.48–8(a)(2), Income Tax Regs., is not unreasonable or inconsistent with section 48(k) and is, therefore, valid." Petitioner has not shown that the film met the conditions of this regulation, and therefore the investment tax credit is unavailable. See *Fife v. Commissioner, supra.*[4]

The fourth category consists of reels of film composed of individual film segments that had been or may have been exhibited to the public previously.[5] Respondent asserts that all of the films in this category were "acquired" by petitioner, and thus that only those films the original use of which commenced with petitioner are eligible for the credit. Petitioner maintains that the films were "reconstructed" and therefore constituted new property in its hands. We do not believe that the changes made to petitioner's films amount to a "reconstruction" of the films, and we therefore hold that these films do not constitute new section 38 property in petitioner's hands.

Section 1.48–8(a)(2), Income Tax Regs., provides that once a qualified film is placed in service "*in any medium of exhibition*" (emphasis added) it becomes used property,[6] and states by way of example that "a film previously exhibited in theaters will not be new section 38 property even when modified for television."

Section 1.48–8(e)(9), Income Tax Regs., defines certain "subsequently incurred costs" for which the investment tax credit is allowable in years after the film is placed in service. See section 1.48–8(a)(1) and (2), Income Tax Regs. The only allowable subsequently incurred costs are those incurred in "preparing prints placed in service within 12 months after the film * * * is initially released for public exhibition in any medium, residuals * * *, and participations."[7] The regulation specifically states that "the cost of additions, modifications, or editing of a film for a new medium incurred after the film is placed in service, is not includible in production costs."

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[4] Cf. *Nabakowski v. Commissioner*, T.C. Memo. 1982–743. Petitioner stipulated that the fee of $1,800 "covered the nitrate print, the negative, some editing and restoration work, and the prints." Without more evidence, we are unable to conclude that "some editing and restoration work" amounted to reconstruction of the property. See discussion *infra*.

[5] With respect to the stipulation that the film segments "may have been" exhibited previously, we reach the same conclusion that we reached *supra*; namely, that petitioner has not met its burden of proving that the films had never been released. Rule 142(a). We therefore presume, for this issue, that all film segments were exhibited previously.

[6] The term "medium of exhibition" is defined in the regulation to include, "for example, free television (network telecasts and television syndications) or movie theaters. The term does not include the video tape or video disc household markets." Sec. 1.48–8(a)(2), Income Tax Regs.

[7] "Residuals" and "participations," defined in sec. 1.48–8(e)(3) and (4), Income Tax Regs., relate to contingent compensation payments and are not relevant to the instant case.

Thus, the regulations address additions, modifications, and editing changes made to adapt a film to a new medium. They specifically state that the costs of making such changes are not eligible for the investment tax credit if the changes are made in years after the films have been placed in service. We think the clear implication of the regulations is that such changes do not amount to "reconstruction" of the property.

In the case before us, petitioner has failed to prove that the nature of its modifications amounted to more than the changes dismissed as "subsequently incurred costs" in the regulations. The stipulation states, for example, that petitioner purchased used cartoons and short subjects, "arranged to splice two or three cartoon and/or short subjects together," and distributed them as reels of two or three. Other footage was described only as having been "spliced together" and edited in some mysterious "miscellaneous" manner. Musical variety entertainment was described only as having been "compiled and distributed as packages." These modifications, without more, do not create "reconstructed" films.

Issue 2. Qualified Films

Some of petitioner's films had not been released before petitioner acquired them, and therefore constitute new section 38 property. As to several of these films, however, respondent argues that they do not constitute "qualified" films within the meaning of section 48(k)(1)(B). Specifically, respondent maintains that the following films are not qualified: (1) "Bullfights from Spain," (2) "Around the Beatles," (3) "Beatles at Shea Stadium," and (4) "Beatles Concert in Tokyo," "Beatles Concert in Washington, D.C."

Section 48(k)(1)(B) defines the term "qualified film" as—

> any motion picture film or video tape created primarily for use as public entertainment or for educational purposes. Such term does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature.

Respondent maintains that "Bullfights from Spain" and the Beatles films are films the markets for which are "primarily topical or otherwise essentially transitory in nature." This Court examined this statutory language and the pertinent regulation for the first time in *Goodson-Todman Enterprises,* *Ltd. v. Commissioner*, 84 T.C. 255 (1985), on appeal (2d Cir., May 31, 1985). See also *Cosby v. United States*, 8 Cl. Ct. 428 (1985). The regulation states as follows:

> (iii) *Topical or transitory films and tapes.* The term "qualified film" does not include any film or tape the market for which is primarily topical or is otherwise essentially transitory in nature. A film or tape is topical or essentially transitory in nature if it primarily deals with events and personalities of current interest at the time the film or tape is placed in service. It does not matter that a film or tape which is topical or essentially transitory in nature may be shown in subsequent years or is actually shown in subsequent years. These films or tapes include news shows such as the evening news and news specials relating to current affairs, interview shows such as "The Tonight Show" or "Meet the Press", game shows, award shows, and shows consisting of sporting events. Similarly, variety shows do not qualify for the credit since they present entertainers primarily as personalities of current interest, as opposed to dramatic or situation comedy shows which present entertainers as characters in a dramatization. Topical or transitory films and tapes do not include, however, dramatized recreations of recent events. [Sec. 1.48–8(a)(3)(iii), Income Tax Regs.]

It seems that this regulation requires us to examine the subject matter of the film at the time the film is placed in service. Timing is crucial, because a film concerning events and personalities of current interest when the film is made may no longer contain current subject matter when it is placed in service.

A film is placed in service:

> when it is first exhibited or otherwise utilized before the primary audience for which the qualified film was created. Thus, a qualified film is placed in service when it is first publicly exhibited for entertainment purposes * * *. * * * A qualified film is not placed in service merely because it is completed and therefore in a condition or state of readiness and availability for exhibition * * * [Sec. 1.48–8(a)(5), Income Tax Regs.]

The films at issue were placed in service sometime during or after 1977. We therefore must determine whether the subject matter of the films concerned events and personalities of current interest sometime during or after 1977.[8]

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[8] The regulation's definition of a topical film as one relating to events and personalities of current interest, comports with the commonly accepted meaning of the term "topical" as "local or designed for local application," "referring to the topics of the day or place," or "of local or temporary interest." The term "transitory" means "tending to pass away," "not persistent," or "of brief duration." *Goodson-Todman Enterprises, Ltd. v. Commissioner*, 84 T.C. 255, 277 (1985), on appeal (2d Cir., May 31, 1985); *Cosby v. United States*, 8 Cl. Ct. 428 (1985).

Respondent maintains that "Bullfights from Spain" is a film consisting of sporting events," and therefore is specifically disqualified by section 1.48–8(a)(3)(iii), Income Tax Regs. We believe, however, that respondent is reading the language of the regulation out of context. Films of sporting events are aimed at topical or transitory markets only if the sporting events are "current" when the film is placed in service. While bullfighting may be a "sport," it may also be a subject of long-term cultural and historical interest. This film was not aimed at a market interested in bullfighting as a current sporting event, but rather was aimed at a market consisting of colleges, religious institutions, shipping lines, movie studios, and production companies. In *Goodson-Todman Enterprises, Ltd. v. Commissioner, supra* at 275, we declined to interpret the regulation as if it established a blanket rule that all game shows are not qualified films. We stated that "To so presume would require us to hold the regulation invalid" because it would exclude game shows that are not, in fact, aimed at topical or transitory markets. See also *Cosby v. United States, supra*. This reasoning applies with equal force to films of sporting events. Because "Bullfights from Spain" was not aimed at a market interested in bullfighting as a current sporting event, we hold that the film meets the current interest test.

Respondent argues that the Beatles' films are "merely recording[s] of performances or events which are primarily topical, regardless of the fact that the films may be shown repeatedly in subsequent years. They do not show the Beatles * * * as characters in a dramatization." We think that, among other things, respondent has overlooked the importance of timing on this issue. Even if it can be argued that the footage may have been disqualified as being topical at the time it was filmed, by 1977, the concerts can hardly have been called "events of current interest," or events of local or temporary interest. See note 8 *supra*. And to argue that the films must show the Beatles as characters in a dramatization in order to qualify is to miss the whole point of the regulation and possibly the Beatles as well. The statute and the regulation seek to exclude films that are merely of current or topical interest; they certainly do not require that events be portrayed through dramatized re-creations rather than live footage. The language in the regulation pertaining to dramatized re-creations of events merely provides an exception to the current interest rule: events that appeal to topical or transitory markets may be portrayed in qualified films if they are portrayed through dramatized re-creations rather than through live footage. Since, in any event, the Beatles' concerts were no longer "topical" in 1977, if indeed they ever were, the language has no application here.

Issue 3. Amount of Credit Available

Petitioner claimed an investment tax credit equal to 10 percent of the total cost it incurred in acquiring or reconstructing the films at issue. Respondent maintains that to the extent any credit is allowable, petitioner may claim only 10 percent of 66⅔ percent of the basis of the property.

Section 48(k)(2) provides that "except as provided in paragraph (3), the applicable percentage under section 46(c)(2)[9] for any qualified film shall be 66⅔ percent." Paragraph (3) of section 48(k) states that:

> (A) IN GENERAL.—If the taxpayer makes an election under this paragraph, the applicable percentage under section 46(c)(2) shall be determined as if the useful life of the film would have expired at the close of the first taxable year by the close of which the aggregate amount allowable as a deduction under section 167 would equal or exceed 90 percent of the basis of the film. [Sec. 48(k)(3)(A).]

The 90-percent rule, in contrast to the general rule of section 48(k)(2), requires a determination of useful life on a film-by-film basis, and each film's useful life is treated as ending "at the close of the year by the end of which the aggregate allowable deductions for depreciation equal at least 90 percent of the basis of the film." Joint Comm. on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, at 177–178, 1976–3 C.B. (Vol. 2) 189–190.

The 90-percent rule is available to a taxpayer only if the taxpayer makes a proper election. Sec. 48(k)(3)(B); sec. 1.48–8(c)(2), Income Tax Regs. For taxable years ending before April 5, 1979, including the years at issue in the instant case, the election is valid only if the taxpayer files by July 5, 1979, a return or amended return with the District Director having audit jurisdiction over the last return to which the election relates indicating that the taxpayer wishes section 48(k)(3) to apply.

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[9] Sec 46(c)(2) is the general code section that prescribes the amount of investment tax credits available for eligible property.

Petitioner's Federal income tax returns were admitted into evidence, and having examined them we conclude that the returns give no indication that petitioner wished to elect the application of section 48(k)(3). Therefore, only the amount provided in section 48(k)(2) is allowable as a credit.

Decision will be entered under Rule 155.

ARNOLD T. FORSETH, ET AL.,[1] PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 27126–82, 1685–83, 7702–83, 7703–83, 32763–83, 2544–84, 3346–84. Filed July 30, 1985.

P's were introduced to a company in London, LMEI, by an American corporation known as InterAct Trading Corp., to which they made certain payments. In late 1980, and in one instance, in late 1981, P's opened accounts with LMEI or its successor, LMEC, transmitting margin deposits and authorizing the companies to conduct discretionary trading in forward contracts in gold and platinum for such accounts. In 1980 and 1981, P's claimed either ordinary or capital losses relative to straddle transactions reflected in their accounts. In 1980, certain P's also claimed advisory fee deductions for their payments to InterAct.

Held, since the transactions in issue were factual shams, inspired, designed, and executed by LMEI and its successor LMEC, with the participation of InterAct, for the sole purpose of achieving the foregoing losses, neither such losses nor the advisory fee deductions claimed by P's are allowable. *Held, further*, this result is not changed by sec. 108 of the Tax Reform

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[1] Cases of the following petitioners are consolidated herewith: Gerald R. Formsma and Constance Y. Formsma, docket No. 1685–83; Stephen A. Mahoney III and Mary Ann Mahoney, docket No. 7702–83; Richard H. Bramblett and Patsy J. Bramblett, docket No. 7703–83; David C. Enrici and Marianne Enrici, docket No. 32763–83; Raymond Wooldridge and Ida Wooldridge, docket No. 2544–84; Lawrence H. Easterling, Jr., and Phyllis R. Easterling, docket No. 3346–84.

Act of 1984, since that section is inapplicable to alleged straddles which are in fact fake or fictitious. *Miller v. Commissioner*, 84 T.C. 827 (1985). *Held, further*, R's determinations of additions to tax for negligence against four P's are upheld.

Edward G. Lavery and *Larry K. Hercules*, for the petitioners.
William P. Hardeman, for the respondent.

KÖRNER, *Judge*: Respondent determined deficiencies in Federal income taxes plus additions to tax against petitioners in these cases as follows:

Petitioners	*Docket No.*	*Taxable year*	*Deficiency*	*Additions to tax sec. 6653(a)*[2]
Arnold T. Forseth[3]	27126–82	12/31/80	$18,664.00	$933.00
Gerald R. Formsma and Constance Y. Formsma	1685–83	12/31/80	40,335.00	2,016.75
Stephen A. Mahoney III and Mary Ann Mahoney	7702–83	12/31/80	21,267.00	
Richard H. Bramblett and Patsy J. Bramblett	7703–83	12/31/80	60,708.85	3,035.44
David C. Enrici and Marianne Enrici	32763–83	12/31/80	452,509.00	
Raymond Wooldridge and Ida Wooldridge	2544–84	12/31/80	32,201.00	
		12/31/81	43,286.00	
Lawrence H. Easterling, Jr., and Phyllis R. Easterling[4]	3346–84	12/31/80	65,692.00	3,285.00

After concessions, the issues remaining for decision are: (1) Whether petitioners are entitled to deduct losses resulting from the dispositions by a corporate entity in London known as L.M.E. Investments, Ltd., and its successor, L.M.E. Commodities, Ltd., of certain alleged positions in forward contracts in gold and platinum; (2) whether petitioners Formsma,

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[2] All statutory references herein are to the Internal Revenue Code of 1954 as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

[3] By answer filed Jan. 10, 1983, respondent asserted an additional deficiency and addition to tax against petitioner Forseth in the respective amounts of $885 and $45.

[4] By amended answer filed on May 25, 1984, respondent claimed an additional deficiency against petitioners Easterling, in an unspecified amount, relative to their claimed business expense deduction for a fee of $4,500 paid to an entity known as InterAct Trading Corp.

Mahoney, Enrici, Wooldridge, and Easterling are entitled to deduct certain fees paid to InterAct Trading Corp. relative to such transactions; and (3) whether petitioners Forseth, Formsma, Bramblett, and Easterling are liable for the foregoing additions to tax for negligence.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

As of the dates of filing their petitions herein, petitioners resided in the following locations:

Petitioners	*Docket No.*	*Residence*
Forseth	27126–82	Waukesha, Wisconsin
Formsma	1685–83	Elkhart, Indiana
Mahoney	7702–83	Cleveland Heights, Ohio
Bramblett	7703–83	Dallas, Texas
Enrici	32763–83	Orinda, California
Wooldridge	2544–84	Atlanta, Georgia
Easterling	3346–84	Redwood City, California

In each case, petitioners timely filed individual income tax returns, Forms 1040, with the Internal Revenue Service for the years in issue, using the cash method of accounting. For such years, all petitioners filed in married filing joint return status, except for petitioner Forseth, who filed in married filing separate return status.[5]

L.M.E. Investments, Ltd. (hereinafter LMEI) was a commodity brokerage firm formed in 1972 by Paul Martin, who was its owner and director, and James Gourlay, who may have had an ownership interest in the company. Both men had previously been associated with Rudolf Wolff & Co., a London brokerage firm dealing in commodity transactions on the London Metal Exchange, a recognized international market in nonferrous metals which had been in existence for over 100 years. However, LMEI was a private corporate entity, in no way related to the London Metal Exchange. When Martin and

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[5] Petitioners Constance Y. Formsma, Mary Ann Mahoney, Patsy J. Bramblett, Marianne Enrici, Ida Wooldridge and Phyllis R. Easterling were joined in this matter because they filed joint returns with their respective petitioner-spouses for the years in issue. As used herein, "petitioner" followed by the surname, refers to the male petitioner, and "petitioners" followed by the surname, refers to both.

Gourlay formed LMEI, they took with them Paul Gleeson, an employee of Rudolf Wolff & Co., who assisted them at LMEI in placing orders, servicing clients, and keeping records.

In February of 1980, Paul Martin died. In or about May of 1981, as a result of the administration of Martin's estate, LMEI was liquidated, and a successor corporation named L.M.E. Commodities (hereinafter LMEC) was formed to carry on essentially the same business for the same accounts. The ownership and directorship of the successor corporation were assumed by Gourlay (for convenience, LMEI and LMEC are hereinafter collectively referred to, where appropriate, as LMEI/LMEC).

At a meeting of financial planners in California in 1980, Paul Gleeson met Robert Ketron, who was at that time a professional geographer. While he had no prior experience trading in commodities, Ketron had recently developed an interest in world commodity markets in an effort, as he stated, to "expand my horizons to meet the challenging times * * * ahead." At Gleeson's invitation, Ketron traveled to London to observe and evaluate LMEI's operations.

After his return from London, Ketron was involved in the formation of a corporation known as InterAct Trading Corp. (hereinafter InterAct), in which he was a 50-percent shareholder. InterAct's literature described the corporation as "a Cleveland-based advisory firm which provides informational services as to how to contact broker-traders who deal in metals in foreign markets."

After the formation of InterAct, Ketron, acting on behalf of the corporation, employed the services of a certified public accountant named Robert Warshawsky to evaluate the operations of LMEI. At Ketron's request, Warshawsky traveled to London in November of 1980, where he met with a number of LMEI's employees, including Gleeson and Gourlay, and inspected its computer system and certain of its records.

In an effort to verify that certain commodity trades were actually being made by LMEI, Warshawsky inspected certain warehouse receipts, but he neither inspected any documentation respecting trades in gold or platinum, nor made any effort to verify that LMEI was "laying off" its contracts, as described *infra*, with third parties.

Warshawsky's examination of LMEI failed to provide a basis for him to evaluate the bona fides of its straddle transactions in gold and platinum forward contracts. However, in a letter dated November 24, 1980, reporting on the results of his examination of LMEI to Ketron, Warshawsky noted, inter alia, that the company "is not especially qualified to trade gold and platinum contracts by virtue of experience or expertise, although they have done so to a limited extent."

In late 1980, InterAct entered into an agreement with LMEI whereby it would refer investors to LMEI, and the two corporations would split evenly all commissions from any resulting trades. InterAct promoted LMEI to interested investors through a network of financial advisers it employed and with whom Ketron was personally acquainted. In the cases of at least several petitioners, their InterAct advisers were also their regular financial advisers and/or accountants, who also prepared their Federal tax returns.

The financial advisers who referred investors to InterAct, as well as some investors, were provided with an information package which included a document styled "Advisor Information Sheet - Commodity Trading Account," pertaining to accounts opened during 1980. Under the heading "Tax Analysis," the Advisor Information Sheet stated, in part, as follows:

> As part of its services to advisors, [InterAct] suggests a computer tax analysis for each of the advisor's clients who contemplate establishing a trading account. The analysis is based upon the clients [sic] estimate of future income, and calculates taxable income, tax liability and projected results of an investment in a trading account.

Appearing at the top of the Advisor Information Sheet was the following table, reproduced verbatim:

	Margin cash	*Advisory fee*	*Possible tax deductions this year*	
Accounts through November 1	$6,250	$2,000	$50,000	(minimum account)
	10,000	2,000	80,000	
	12,500	2,500	100,000	
	25,000	5,000	200,000	

	Margin cash	*Advisory fee*	*Possible tax deductions this year*	
Accounts through December[6]	$7,500	$2,000	$50,000	(minimum account)
	12,000	2,000	80,000	
	15,000	2,500	100,000	
	30,000	5,000	200,000	
Accounts through December 22	$8,750	$2,000	$50,000	(minimum account)
	14,000	2,000	80,000	
	17,500	2,500	100,000	
	35,000	5,000	200,000	

The information package also included: (1) Sample Federal tax returns for individuals, corporations, and partnerships, recommending in the case of individuals that investors should report losses simply as "contract cancellation charges" (no entries explaining how to report profits are shown on such forms); (2) a description of procedures to follow in the event of an Internal Revenue Service audit, including an admonition that advisers and clients "should be notified in advance that any information they communicate to IRS agents could produce unfavorable ramifications;" (3) a number of documents explaining the profit and loss potential in trading certain commodity straddles; and (4) a statement of principles, including the requirement that the investor have an annual "taxable income" of at least $50,000, and at least $200,000 in assets in order to be eligible to use InterAct's services.

Also included in the information package was a document styled "Investment Criteria of Forward Contracts," which provided, inter alia, as follows:

> For the Forward Contracts to produce a capital gain or loss, I.R. Code Section 1222 requires that there be a "sale or exchange" of a CAPITAL ASSET. * * *
>
> Recognizing that the investor does not have a complete sale or exchange when the Forward is cancelled, the gain or loss resulting from the cancellation should be treated as an ordinary gain or loss.

With the exception of petitioner Mahoney, each petitioner opened an account with LMEI/LMEC by executing a trading authorization which granted it discretionary authority to manage his account, including authority, inter alia, "to give and place any and all orders or purchase and/or sell (including short sales) and otherwise trade in commodities, commodities forward contracts, and/or commodities futures contracts, on margin or otherwise." Each such petitioner executed such a trading authorization in advance of any trading activity on his account, except for petitioner Easterling, whose trading authorization was dated December 7, 1980, but for whom trading was begun on December 5, 1980. Petitioners did not instruct LMEI/LMEC in their trading authorizations or otherwise to limit losses which might be sustained on their accounts.

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[6] The date appearing on this line is illegible on the exhibit entered into evidence.

With the exception of petitioner Bramblett, who had no dealings with InterAct, each petitioner was introduced to LMEI/LMEC through InterAct, and certain petitioners made payments to the latter corporation, as follows:

TABLE 1

Petitioner	*Date of payment*	*Amount*
Formsma	12/15/80	$2,000
Mahoney	[7]10/24/80	1,250
Enrici	12/22/80	22,500
Wooldridge (1980)	12/10/80	2,000
Wooldridge (1981)[8]	11/24/81	6,000
Easterling[9]	- - -	4,500

The foregoing petitioners paid such fees to InterAct in the belief that they were for continuing informational services concerning their investments with LMEI/LMEC.

Unlike the other petitioners, Mahoney had a 21.7391-percent interest in an LMEI/LMEC account, numbered 04975, which was opened in the name of Avery Klein as nominee. Klein was a certified public accountant, one of whose clients was Robert Ketron. Klein maintained two accounts with LMEI/LMEC for trading in gold and platinum, each of which was held on behalf of a different group of investors who were also clients of his accounting practice. Klein granted LMEI/LMEC full discretionary management authority with respect to his accounts. For his services, which included keeping track of paperwork for his client-investors, Klein received as his fee, 40 percent of the fee that was paid to InterAct.

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[7] Mahoney's fees were paid to an individual named Avery Klein on the date indicated. The record does not disclose the date Klein transmitted the fees to InterAct.

[8] Petitioner Wooldridge opened separate accounts with LMEI/LMEC numbered 10994 and 96500, for 1980 and 1981, respectively.

[9] The date of Easterling's payment to InterAct is not disclosed on this record. Petitioners' contention that the Easterling payment was actually made relative to an unrelated pistachio nut growing venture, however, is clearly belied by his admission at trial that he paid this amount to InterAct and then deducted it on his return as an advisory fee.

When potential investors sought to open an account with LMEI/LMEC through InterAct, they were explicitly required by InterAct to first call LMEI/LMEC and then transmit to it a completed account registration form and cashier's check to cover initial margin requirements. In the words of Paul Gleeson, the margin requirements constituted LMEI/LMEC's "insurance policy against risk."

During the years in issue, petitioners' margin accounts with LMEI/LMEC reflected the following credits for payments and, in some instances, transfers of funds from such account to separate and unrelated accounts maintained by petitioners in other commodities which were allegedly traded in pounds sterling:

TABLE 2

		Initial payment		*Transfer of funds*		
Account	*Account No.*	*Date posted*	*Amount*	*Date posted*	*Amount*	*Net margin*
Forseth	02778	12/31/80	$7,500	12/31/80	($1,250)	$6,250
Formsma	02777	12/22/80	19,000	01/06/81	(9,000)	10,000
Klein	04975	11/10/80 11/11/80	28,750	12/24/80	(3,250)	25,500
Bramblett	01046	12/31/80	15,000	- - -	- - -	15,000
Enrici	02605	12/29/80	100,000	01/08/81	(10,000)	90,000
Wooldridge (1980)	10994	12/15/80	10,000	12/15/80	(1,625)	8,375
Wooldridge (1981)	96500	12/02/81	10,000	- - -	- - -	10,000
Easterling	02475	12/02/80	27,000	01/08/81	(4,500)	22,500

Petitioner Bramblett's payment of $15,000 was made by means of a check dated December 23, 1980, and drawn on the Republic National Bank of Dallas.

Petitioner Forseth's payment of $7,500 was made by means of a wire transfer on December 30, 1980, from a bank located in Waukesha, Wisconsin, to the Bank Nationale of Paris. At trial, Forseth did not know why the margin for LMEI/LMEC in London was wired to an entity located in Paris, but he did know that it was wired in the morning, Wisconsin time. Since the time in Paris is 7 hours ahead of the time in Waukesha, the funds could not have been posted to the Paris account before late afternoon on December 30, 1980, and as noted in table 2, they were posted to Forseth's account with LMEI/LMEC on the following day.

Of the initial margin in the Klein account of $28,750, a 21.7391-percent share, or $6,250, was paid by petitioner Mahoney.

As of the time of trial in this matter, none of the foregoing accounts had been subject to a margin call by LMEI/LMEC, and no petitioner had posted any additional margin.[10]

Beginning in November and December of 1980, pursuant to its discretionary authority, LMEI/LMEC entered into a number of alleged transactions on behalf of Avery Klein and petitioners Forseth, Formsma, Bramblett, Enrici, Wooldridge, and Easterling. The transactions were structured in the form of intercommodity straddles, comprised of offsetting long and short forward contracts in equal quantities of gold, on the one side, and platinum, on the other. The straddles were quantity-balanced, rather than price-balanced, because the prices of gold and platinum remained close during the years in issue, and one could only purchase gold and platinum in 100 troy ounce units.

Such forward straddles are similar in form to the futures straddles described in some detail by this Court in *Smith v. Commissioner*, 78 T.C. 350, 354–357 (1982), except that forward contracts are agreements between principals which are not traded on any recognized exchange. Unlike futures traded on regulated exchanges, the alleged LMEI/LMEC forward trades were not subject to any limits on price movements which could occur during each trading day. The price of a forward contract on an unregulated market will not necessarily be the same as an otherwise comparable futures contract on a regulated exchange.

On their individual income tax returns for 1980 and 1981, petitioners claimed the following losses relative to their accounts with LMEI/LMEC:

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[10] While petitioner Wooldridge testified that he posted additional margin of $1,000 after 1981, and LMEI/LMEC's trading records reflect a credit in that amount on Apr. 19, 1982, we believe that Gleeson's confirmation at trial that no margin calls were ever made coupled with Wooldridge's failure to produce a canceled check or other evidence to corroborate his testimony, convinces us that such amount, if paid by him at all, was for purposes other than posting additional margin.

TABLE 3

		Loss reported	
Petitioner	*Year*	*Amount*	*Character*
Forseth	1980	$50,400	ordinary
Formsma	1980	80,500	ordinary
Mahoney	1980	50,022	ordinary
Bramblett	1980	121,300	ordinary
Enrici	1980	1,732,000	capital
Wooldridge	1980	66,500	ordinary
	1981	102,700	ordinary
Easterling	1980	177,600	ordinary

The foregoing claimed losses resulted from the alleged closing of certain forward contracts by cancellation or offset in 1980 and 1981. When a position was closed by cancellation, LMEI/LMEC purported to extinguish the responsibilities of the investor thereunder, debiting his account for a "cancellation fee" equal to the amount of loss inherent in the position. In such instances, petitioners had no way of knowing, and did not know, how the amount of the loss was determined. When a position was closed by offset, on the other hand, LMEI/LMEC allegedly would enter into an opposite contract for the purchase or sale of the same quantity of the same commodity on the same delivery date. In the instant cases, all losses claimed by petitioners resulted from the closing of positions by cancellation, with the exception of petitioner Enrici, whose loss positions were all closed by offset.

The transactions reflected in petitioners' accounts, which gave rise to the foregoing claimed losses, were as follows:

TABLE 4

		Transaction						
Account		*Date*	*Description*	*Contract No.*[11]	*Delivery date*	*Troy ounces*	*Price per troy ounce*	*Gain/loss*
Forseth	(1)	12/30/80	[12]Short P	[13]120796(3)	08/31/82	2400	$684	
	(2)	12/30/80	Long G	120563	04/30/82	2400	680	
	(3)	12/31/80	CANCEL	120796(1)	08/31/82	2400	705	[14]($50,400)
	(4)	12/31/80	Short G	121167	06/30/82	2400	712	

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[11] This number denotes either the number of the long or short contract entered into, or in the case of a cancellation or offset entry, the number of the contract canceled or offset.

[12] "P" denotes platinum and "G" denotes gold.

[13] The parenthetical number cross references the line describing the contract which was canceled or offset.

[14] This loss figure is computed as the difference between the products of the ounces and price of contract number 120796 on 12/30/80 and on 12/31/80, when it was canceled.

		Transaction						
Account		*Date*	*Description*	*Contract No.*	*Delivery date*	*Troy ounces*	*Price per troy ounce*	*Gain/loss*
Formsma	(1)	12/12/80	Short G	117560(7)	02/12/82	600	$632	
	(2)	12/12/80	Long P	117522	04/12/82	600	633	
	(3)	12/16/80	Long P	117831	04/16/82	500	648	
	(4)	12/16/80	Short G	117957(10)	02/16/82	500	647	
	(5)	12/17/80	Long P	118685	04/16/82	300	664	
	(6)	12/17/80	Short G	118702(9)	02/16/82	300	663	
	(7)	12/23/80	CANCEL	117560(1)	02/12/82	600	[15]701	($41,400)
	(8)	12/23/80	Short P	119195	06/24/82	600	712	
	(9)	12/24/80	CANCEL	118702(6)	02/16/82	300	706	(12,900)
	(10)	12/24/80	CANCEL	117957(4)	02/16/82	500	[16]699.40	(26,200)
	(11)	12/24/80	Short P	119840	06/24/82	300	712	
	(12)	12/24/80	Short P	119839	06/24/82	500	711	
								(80,500)
Klein[17]	(1)	11/10/80	Long G	114502	06/30/82	1500	725	
	(2)	11/10/80	Short P	114479(9)	02/10/82	1500	708	
	(3)	11/12/80	Long G	114587	07/09/82	1200	741	
	(4)	11/12/80	Short P	114517(13)	02/12/82	1200	712	
	(5)	11/13/80	Long G	115095	06/29/82	1800	727	
	(6)	11/13/80	Short P	114924(14)	02/12/82	1800	708	
	(7)	11/14/80	Long G	115161	06/29/82	1200	723	
	(8)	11/14/80	Short P	114981(11)	02/12/82	1200	710	
	(9)	11/18/80	CANCEL	114479(2)	02/10/82	1500	759	(76,500)
	(10)	11/18/80	Short G	114889	04/07/82	1500	724	
	(11)	11/19/80	CANCEL	114981(8)	02/12/82	1200	742	(38,400)
	(12)	11/19/80	Short G	115049	03/24/82	1200	733	
	(13)	11/20/80	CANCEL	114517(4)	02/12/82	1200	745	(39,600)
	(14)	11/20/80	CANCEL	114924(6)	02/12/82	1800	750	(75,600)
	(15)	11/20/80	Short G	115041	02/26/82	1800	740	
	(16)	11/20/80	Short G	115040	02/26/82	1200	741	([18])
								(230,100)

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[15] Exhibits entered into the record reflect a difference of $1 between the parties with respect to this figure. In the absence of evidence to corroborate either figure in the stipulated trading records, we have adopted respondent's figure, since it is consistent with the total amount of losses claimed by petitioner Formsma.

[16] Exhibits entered into the record reflect a difference of $2.60 between the parties with respect to this figure. For the same reasons described in note 15, we have adopted respondent's figure.

[17] Reflected herein are the transactions relative to Avery Klein's nominee account number 04975, with respect to which petitioner Mahoney owned a 21.7391-percent interest.

[18] Mahoney claimed only losses attributable to his 21.7391 percent share of this account, or $50,022.

		Transaction						
Account		*Date*	*Description*	*Contract No.*	*Delivery date*	*Troy ounces*	*Price per troy ounce*	*Gain/loss*
Bramblett	(1)	12/22/30	Short G	119010	04/22/82	1000	$714	
	(2)	12/22/80	Long P	118994(9)	06/22/82	1000	709	
	(3)	12/23/80	Short G	119223	04/30/82	1500	718	
	(4)	12/23/80	Long P	119207(7)	06/24/82	1500	713	
	(5)	12/24/80	Long P	119788(10)	06/25/82	800	714	
	(6)	12/24/80	Short G	119812	04/30/82	800	719	
	(7)	12/30/80	CANCEL	119207(4)	06/24/82	1500	672	($61,500)
	(8)	12/30/80	Long G	120637	02/23/82	1500	667	
	(9)	12/31/80	CANCEL	118994(2)	06/22/82	1000	678	(31,000)
	(10)	12/31/80	CANCEL	119788(5)	06/25/82	800	678	(28,800)
	(11)	12/31/80	Long G	121070	02/23/82	1000	676	
	(12)	12/31/80	Long G	121071	02/26/82	800	674	
								(121,300)
Enrici	(1)	12/18/80	Short P	118328(21)	04/19/82	5000	668	
	(2)	12/18/80	Short P	118329(27)	04/26/82	6000	669	
	(3)	12/18/80	Long G	118385	02/09/82	6000	666	
	(4)	12/18/80	Long G	118386	02/12/82	6000	664	
	(5)	12/18/80	Long P	118628	02/18/82	5000	655	
	(6)	12/18/80	Long P	118629	02/18/82	6000	656	
	(7)	12/18/80	Short G	118646(17)	04/22/82	6000	679	
	(8)	12/18/80	Short G	118647(15)	04/23/82	6000	677	
	(9)	12/19/80	Short G	118682(19)	04/09/82	5000	709	
	(10)	12/19/80	Short G	118683(23)	04/26/82	6000	679	
	(11)	12/19/80	Long G	118390(31)	02/16/82	5000	696	
	(12)	12/19/80	Long G	118391	02/22/82	6000	666	
	(13)	12/19/80	Long P	118664(35)	02/22/82	4000	664	
	(14)	12/19/80	Short P	118336(29)	04/20/82	4000	676	
	(15)	12/23/80	OFFSET	118647(8)	04/23/82	6000	720	(258,000)
	(16)	12/23/80	Short G	119264	06/23/82	6000	733	
	(17)	12/23/80	OFFSET	118646(7)	04/22/82	6000	721	(252,000)
	(18)	12/23/80	Short G	119263	06/22/82	6000	734	
	(19)	12/23/80	OFFSET	118682(9)	04/09/82	5000	723	(70,000)
	(20)	12/23/80	Short G	119265	06/23/82	5000	732	
	(21)	12/23/80	OFFSET	118328(1)	04/19/82	5000	700	(160,000)
	(22)	12/23/80	Short P	119192	06/22/82	4000	714	
	(23)	12/24/80	OFFSET	118683(10)	04/26/82	6000	721	(252,000)
	(24)	12/24/80	Short G	119881	06/29/82	6000	734	
	(25)	12/24/80	Long P	119863(33)	02/24/82	5000	688	
	(26)	12/24/80	Short P	119836	06/16/82	5000	714	
	(27)	12/24/80	OFFSET	118329(2)	04/26/82	6000	700	(186,000)
	(28)	12/24/80	Short P	119835	06/24/82	6000	715	
	(29)	12/24/80	OFFSET	118336(14)	04/20/82	4000	700	(96,000)
	(30)	12/24/80	Short P	119834	04/23/82	5000	701	
	(31)	12/30/80	OFFSET	118390(11)	02/16/82	5000	666	(150,000)
	(32)	12/30/80	Long G	120619	06/07/82	5000	396	

Account		*Transaction* Date	Description	Contract No.	Delivery date	Troy ounces	Price per troy ounce	Gain/loss
Enrici	(33)	12/30/80	OFFSET	119863(25)	02/24/82	5000	$644	($220,000)
	(34)	12/30/80	Long P	120603	06/25/82	5000	673	
	(35)	12/30/80	OFFSET	118664(13)	02/22/82	4000	642	(88,000)
	(36)	12/30/80	Long P	120604	06/25/82	4000	674	
								(1,732,000)
Wooldridge	(1)	12/09/80	Long P	116777(5)	06/09/82	500	737	
(1980)	(2)	12/09/80	Short G	116794	04/09/82	500	718	
	(3)	12/10/80	Long P	117014(7)	06/15/82	400	713	
	(4)	12/10/80	Short G	117061	04/23/82	400	708	
	(5)	12/12/80	CANCEL	116777(1)	06/09/82	500	648	(44,500)
	(6)	12/12/80	Long G	117565	02/12/82	500	633	
	(7)	12/16/80	CANCEL	117014(3)	06/15/82	400	[19]658	(22,000)
	(8)	12/16/80	Long G	118911	02/16/82	400	642	
								(66,500)
Wooldridge	(1)	06/16/81	Long P	106191(7)	06/15/83	500	581.20	
(1981)	(2)	06/16/81	Short G	106189	04/06/83	500	594.10	
	(3)	06/17/81	Long P	106213(9)	06/22/83	400	578.80	
	(4)	06/17/81	Short G	106215	04/06/83	400	591.70	
	(5)	06/19/81	Long P	106221(11)	06/22/83	500	575	
	(6)	06/19/81	Short G	106225	04/13/83	500	588	
	(7)	07/02/81	CANCEL	106191(1)	06/15/83	500	([20])	(33,100)
	(8)	07/02/81	Long G	106265	02/02/83	500	525.60	
	(9)	07/06/81	CANCEL	106213(3)	06/22/83	400	- - -	(34,000)
	(10)	07/06/81	Long G	106273	02/16/83	400	504	
	(11)	07/07/81	CANCEL	106221(5)	06/22/83	500	- - -	(35,600)
	(12)	07/07/81	Long G	106284	02/09/83	500	513.60	
								(102,700)
Easterling	(1)	12/05/80	Short G	116536	04/08/82	1000	738	
	(2)	12/05/80	Long P	116596(7)	06/09/82	1000	754	
	(3)	12/08/80	Short G	116715	04/09/82	800	733	
	(4)	12/08/80	Long P	116667(9)	06/09/82	800	741	
	(5)	12/10/80	Short G	117047	04/09/82	200	705	
	(6)	12/10/80	Long P	116992(10)	06/15/82	200	714	

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[19] Exhibits entered into the record reflect a difference of $1 between the parties with respect to this figure. For the same reasons described in note 15, we have adopted respondent's figure.

[20] The record does not disclose the prices at which the contracts in Wooldridge's 1981 account were canceled.

	Transaction						
Account	*Date*	*Description*	*Contract No.*	*Delivery date*	*Troy ounces*	*Price per troy ounce*	*Gain/loss*
Easterling	(7) 12/12/80	CANCEL	116596(2)	06/09/82	1000	$653	($101,000)
	(8) 12/12/80	Long G	117434	02/08/82	1000	634	
	(9) 12/16/80	CANCEL	116667(4)	06/09/82	800	659	(65,000)
	(10) 12/16/80	CANCEL	116992(6)	06/15/82	200	659	(11,000)
	(11) 12/16/80	Long G	117862	02/16/82	200	641	
	(12) 12/16/80	Long G	117861	02/09/82	800	639	
							(177,600)

In 1980 and 1981, neither gold nor platinum was traded on the London Metal Exchange or on any other commodity exchange in London. While two daily "fixes" were published, reflecting the price of spot gold for immediate delivery, there were no published prices in London for spot platinum or for forward contracts in gold or platinum. In the instant cases, petitioners had no way of verifying the prices at which LMEI/LMEC allegedly conducted transactions on their behalf.

On their Federal income tax returns for the years in issue, each petitioner, except Enrici, reported gross income and adjusted gross income in the following amounts:

TABLE 5[21]

			Gross income		Adjusted
Petitioner	*Year*	*Item*	*Amount*	*Total*	*gross income*
Forseth	1980	Wages	$13,000		
		Interest	676		
		Supplemental	39,673		
				$53,349	$3,112
Formsma	1980	Wages	122,594		
		Interest	1,697		
		Tax refund	11		
		Fees	31,925		
				157,227	66,203
Mahoney	1980	Wages	21,280		
		Interest	671		
		Dividends	134		
		Supplemental	76,298		
				98,383	30,161
Bramblett	1980	Wages	120,000		
		Fees	72,622		
		Capital gains	2,231		
				194,853	53,124

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[21] The amounts shown in table 5 are rounded to the nearest dollar.

			Gross income		*Adjusted*
Petitioner	*Year*	*Item*	*Amount*	*Total*	*gross income*
Wooldridge	1980	Wages	$154,518		
		Interest	31		
		Dividends	966		
		Business	1,234		
				$156,749	$54,215
Wooldridge	1981	Wages	176,495		
		Interest/dividends	247		
		Capital gains	5,659		
				182,401	30,947
Easterling	1980	Wages	23,903		
		Interest	4,061		
		Business	178,409		
		Farm	31,029		
		Capital gains	251		
				237,653	17,908

The losses claimed by the foregoing petitioners relative to their accounts with LMEI/LMEC, offset the following percentages of their adjusted gross income, exclusive of such losses:

TABLE 6

Petitioner	*Year*	*Percentage of adjusted gross income offset*
Forseth	1980	94%
Formsma	1980	55
Mahoney	1980	62
Bramblett	1980	70
Wooldridge	1980	55
Wooldridge	1981	77
Easterling	1980	91

In the case of petitioners Enrici, their claimed losses from trading in gold and platinum forwards, in the amount of $1,732,000 were combined with certain short-term capital gains and losses from trades in other commodities, as well as with a short-term capital loss carryover from a prior year, for a net short-term capital loss of $1,741,931. Since they also reported net long-term capital gains in the amount of $1,991,748, the Enricis' had a net gain in 1980 of $249,817, of which 40 percent, or $99,927 was reported as taxable in that year.

The Enricis' reported adjusted gross income in 1980 in the amount of $141,949. In the absence of the LMEI/LMEC losses for 1980, they would have reported adjusted gross income in the amount of $834,749, so that the LMEI/LMEC losses offset their adjusted gross income by some 83 percent.

The data reflected in table 4 is taken principally from documentation of trades maintained by LMEI/LMEC, and entered into evidence herein as stipulated exhibits (hereinafter referred to, collectively, as trading records). The entries in the trading records, in turn, were taken, at least in part, from handwritten worksheets which were updated by LMEI/LMEC contemporaneously with the transactions which they purport to reflect. Such worksheets were entered into evidence for the account of each petitioner herein, except the worksheets for the accounts of Wooldridge (1981) and Klein.

After the years in issue, the trading records reflect that LMEI/LMEC took the following actions relative to the open positions remaining in each of the subject accounts, as reflected on table 4:[22]

(1) *Forseth*—The times for delivery on the two open gold positions were extended, first to 1984, and then to 1986, with corresponding changes in the contract prices, such that no gain was realized as of the time of the trial in this matter.

(2) *Formsma*—In or about June of 1982, the six open platinum positions were purportedly sold to a Swiss corporation known as Broadstreet Investments, resulting in a gain of $70,500.

(3) *Klein*—In February and March of 1982, the eight remaining open gold positions were closed by entering into offsetting contracts, for a total gain in the Klein account of $189,240, of which $41,139 was Mahoney's share.

(4) *Bramblett*—The times for delivery on the six open gold positions were extended to February and March of 1984, with corresponding changes in the contract prices, and were then closed by entering into offsetting contracts on February 21, 1984, for a gain of $106,230.

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[22] Petitioners request that we find that certain payments were made by them to an entity known as Broadstreet Investments in return for its agreement to purchase their contracts, and to LMEI/LMEC, in return for its extension of their contracts into future years. Since we find no credible evidence to substantiate the LMEI/LMEC journal entries reflecting such alleged payments, however, we decline to make the requested findings.

(5) *Enrici*—The times for delivery on 14 of the open positions were extended, first to 1984, and then to 1986, with corresponding changes in the contract prices, such that no gain was realized as of the time of the trial in this matter; and the remaining two open platinum positions, contracts 119836 and 120603, were purportedly sold to Broadstreet Investments, resulting in a gain of $209,000.

(6) *Wooldridge*—(a) *1980*—On February 3, 1984, the four remaining open gold positions which had been extended to February and March of 1984, were closed by entering into offsetting contracts, for a gain of $58,320.

(b) *1981*—The times for delivery on the six open gold positions were extended to March and May of 1985, with corresponding changes in the contract prices, such that no gain was realized as of the time of the trial in this matter.

(7) *Easterling*—On February 1, 1982, the six remaining open gold positions were closed by entering into offsetting contracts, for a gain of $155,100.

As a result of the aforedescribed transactions, Avery Klein and those petitioners whose gold and platinum positions were fully liquidated as of the time of the trial in this matter purportedly sustained the following net losses:[23]

TABLE 7

Account	*1980 losses*	*Post-1980 gains*	*Net losses*
Formsma	$80,500	$70,500	$10,000
Klein	230,100	189,240	40,860
Bramblett	121,300	106,230	15,070
Wooldridge (1980)	66,500	58,320	8,180
Easterling	177,600	155,100	22,500

For Klein and the foregoing four petitioners, a comparison of their net losses from table 7, with the balances in their margin accounts net of transfers to unrelated accounts, from table 2, as follows:

TABLE 8

Account	*Margin balance*	*Net losses*	*Difference*
Formsma	$10,000	$10,000	0
Klein	25,500	40,860	($15,360)

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[23] As we have found, a number of positions which were held by petitioners Forseth, Enrici, and Wooldridge (in the 1981 account) were rolled forward into 1985 and 1986.

Account	*Margin balance*	*Net losses*	*Difference*
Bramblett	$15,000	$15,070	($70)
Wooldridge (1980)	8,375	8,180	195
Easterling	22,500	22,500	0

As of the time of the trial in this matter, LMEI/LMEC had not collected the foregoing $70 deficit balance from petitioner Bramblett.

In the case of petitioner Wooldridge's 1981 account, certain manually typed "debit notes," which are included in the trading records, reflect charges in July of 1981 of $33,100, $34,000, and $35,600, as reflected in table 4, for the cancellation of contracts which are described as having been entered into in June of 1981. However, two computer-generated documents contained in the trading records, styled "Statement of Account on Closed Positions," dated December 31, 1981, and April 29, 1983, both reflect the same charges for cancellation of the same contracts, not in July of 1981, but in October of that year.

In the case of Avery Klein's nominee account, in which petitioners Mahoney held a 21.7391-percent interest, the trading records reflect a credit entry on March 3, 1983, in the amount of $15,290. This entry is described solely as "Journal From Related A/C," and remains otherwise unexplained in the LMEI/LMEC documentation. The $15,290 credit entry is netted against the $15,360 debit entry in the trading records, resulting in a so-called "due balance" of $70.

At those times when American markets trading in gold and platinum futures or forward contracts are open, prices on such positions would be generally comparable to prices in other markets around the world. While the price on a foreign market might deviate from the settlement or closing price on an American exchange after the latter has closed, particularly in the event of a major intervening world event, such deviation would not last long and the economic pressures of arbitrage, or buying in one market and selling in another, would soon cause the prices to once again coincide.

The American Board of Trade (hereinafter ABT), located in New York City, is an exchange on which forward contracts in gold and platinum were traded during the years in issue. Like LMEI/LMEC, ABT places no daily limitations on the prices of such commodities. Unlike LMEI/LMEC, ABT regularly publishes in the Wall Street Journal its closing spot and 1- to 12-month forward contract prices in gold, platinum, and other commodities.[24]

For certain dates between January of 1981 and February of 1982,[25] had petitioners liquidated their then-open gold and platinum positions at ABT's published prices for gold and platinum forward contracts,[26] as interpolated,[27] their accounts would have reflected the equity balances shown on page 146.[28]

The five petitioners who made payments to InterAct in 1980 (table 1), claimed deductions for such payments as advisory fees on their 1980 tax returns.

Respondent issued deficiency notices, in which amounts claimed by petitioners as ordinary and capital losses due to the foregoing transactions with LMEI/LMEC, were disallowed in full in all cases except for petitioner Forseth.

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[24] This record fails to disclose the hours of the trading day on the ABT.

[25] Such dates are based upon the dates for which ABT's published forward prices are entered into the record.

[26] Table 9 is based upon the *assumed* liquidation of petitioners' LMEI/LMEC positions at the ABT prices, as interpolated to the same delivery date. The record is inconclusive as to whether or not any bona fide forward obligations in gold and platinum entered into by LMEI/LMEC could have been liquidated on the American exchange.

[27] The interpolation of prices from ABT's published prices for 6- and 12-month forward delivery was required because the delivery dates for ABT forward contracts, as entered into the record herein, do not coincide with the delivery dates for petitioners' post-1980 open positions with LMEI/LMEC. The computations of the interpolated prices were prepared by respondent's agent, Fred Swinford, and admitted into the record herein. Swinford described the manner in which the interpolations were computed as follows:

> "For instance, if you were to take the twelve month spot price of $695.40 and subtract the six month spot price of $640.25 from it, you will get * * * $55 and divide that by the number of days in six months, which is approximately 182.5 days. You will come up with a daily increase in the value. This means that for every day beyond a year that the contract goes out, its cost will have to rise 30 cents a day.
>
> "* * * the farther out a contract gets, the more costs are involved, because you have to take into account interest, storage, other factors. So * * * I would merely take the twelve month spot and then add to it the number of days times the daily factor till I arrived exactly at the delivery date as shown on the LME contract."

[28] In the case of petitioners Bramblett, for example, the account equity balances for the dates chosen were computed as follows: First, the account equity balances for the period immediately following liquidation of the 1980 positions at a loss and the switches to new straddle positions was computed as the sum of: (a) Bramblett's total margin payments, or $15,000; (b) the sum of the loss positions liquidated in 1980, or ($121,300); and (c) the net equity remaining in those positions which were still open after 1980, computed according to the LMEI/LMEC prices, or $150,500. Second, the account equity balance for such period, thus derived, was added to the net debit value which would result from liquidation of all of the open positions at the ABT prices, as interpolated, at each of the various dates shown, thus yielding the net account equity balances shown in table 9.

TABLE 9

Account equity balances

Account	*1/29/81*	*2/26/81*	*3/30/81*	*4/30/81*	*6/1/81*	*7/15/81*	*9/1/81*	*10/1/81*	*11/30/81*	*12/30/81*	*2/1/82*
Forseth	($86)	$1,042	$1,618	$1,138	$16,666	$8,098	$17,746	$17,194	$13,306	$10,618	$11,722
Formsma	546	978	(3,902)	3,544	8,828	5,078	4,248	11,220	12,758	9,198	13,124
Klein	(31,269)	(36,105)	(38,487)	(36,492)	(106,155)	(64,956)	(79,452)	(74,646)	(87,678)	(78,786)	(89,862)
Bramblett	(2,182)	(755)	1,978	(453)	21,927	9,442	3,558	1,008	17,009	15,847	27,608
Enrici	(24,480)	(30,440)	(72,320)	(3,630)	311,990	129,750	157,780	157,000	290,800	243,450	337,050
Wooldridge (1980)	(1,389)	(970)	(765)	(939)	4,929	1,652	(1,062)	226	3,870	3,551	6,423
Easterling	10,832	10,722	12,163	11,800	24,370	17,344	14,120	12,900	22,354	21,682	27,772

In the case of petitioner Forseth, the claimed ordinary loss was not allowed as an ordinary loss, but a short-term capital loss of $1,500 was allowed. In his answer, however, respondent affirmatively pleaded various grounds for complete disallowance of the claimed loss, and then in the alternative, pleaded that the loss was not an ordinary loss but a capital loss, subject to the limitations of section 1211.

The deficiency notice also disallowed advisory fee deductions claimed for 1980 in the cases of petitioners Enrici, Formsma, and Wooldridge for their payments to InterAct. In his amended answer in docket No. 3346-84, for which leave to file was granted on May 25, 1984, respondent affirmatively pleaded for an increased deficiency due to disallowance of the advisory fee deduction claimed by petitioners Easterling.[29]

Respondent determined additions to tax for negligence solely against petitioners Forseth, Formsma, Bramblett, and Easterling.

During the years in issue, Forseth was self-employed as an excavation and landscaping contractor, Forsma was the president and owner of an anodizing company, Bramblett was in the real estate development and consulting business, and Easterling was a licensed real estate agent. Prior to selling real estate, Easterling was a securities salesman for 15 years, and for part of that period he had his own firm which, among other things, "handled tax shelters." While neither Forsma nor Bramblett had prior experience in trading commodities, Bramblett had been involved in investing in the stock market for 20 to 25 years. On the other hand, Forseth had previously traded in commodities, and Easterling had some exposure to commodity trading in his securities business and was aware of the possibilities for making or losing money in such investments.

On their 1980 Federal income tax returns, petitioners Forseth, Formsma, Bramblett, and Easterling reported LMEI/LMEC losses as follows:

(a) Forseth: "Platinum contract cancelled"
(b) Formsma: "Contracty cancellation charges"
(c) Bramblett: "Loss on cancellation of forward contract"

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[29] Respondent's motion to file a similar amendment to his answer in the case of petitioners Mahoney was only filed on Oct. 1, 1984, and was denied by the Court.

(d) Easterling: "Comm Trading - FWD Contract CA"

While petitioners Forsma appended to their return three "debit notes" bearing the LMEI/LMEC letterhead, none of the foregoing four petitioners identified LMEI or LMEC on their Forms 1040 for 1980, or on the schedules appended thereto.

On Part III of Schedule B (Interest and Dividend Income) of the 1980 Form 1040, entitled "Foreign Accounts and Foreign Trusts," the following question appears:

> A. At any time during the tax year, did you have an interest in or a signature or other authority over a bank account, securities account, or other financial account in a foreign country?

In 1980, petitioners Easterling, Formsma, and Forseth filed Schedules B with their returns. On the returns of Easterling and Formsma the "no" box is checked in answer to the foregoing question. On Forseth's return, no answer is checked, and Bramblett did not file a Schedule B or otherwise disclose the foreign nature of his account in 1980.

OPINION

The principal issue for decision is whether petitioners may deduct losses resulting from the discretionary disposition by LMEI/LMEC for their accounts of the loss legs of the alleged gold and platinum forward straddles reflected on table 4.

Petitioners contend that the transactions in question were bona fide and had economic substance. They further assert that the profit standard of section 108 of the Tax Reform Act of 1984[30] applies, but that their transactions were entered into for profit whether evaluated under this standard or under the prior profit motive standard enuciated by this Court in *Smith v. Commissioner, supra*. As to all cases except petitioners Enrici, petitioners further allege that the subject losses are ordinary losses as claimed, rather than capital losses as asserted by respondent.

Respondent, on the other hand, asserts that the losses should be disallowed because the alleged forward contracts are fictitious or preconceived shams lacking economic substance. Respondent further contends that the losses are allowable neither under the profit test of section 108 nor under *Smith*. In the alternative, in the event that the contracts giving rise to the subject losses are found to have economic substance and to have been entered into for profit under the applicable standard, respondent insists that such losses are capital rather than ordinary in nature (a point which is conceded in the case of petitioners Enrici).

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[30] Division A of the Deficit Reduction Act of 1984, 98 Stat. 494.

For the following reasons, we agree with respondent that the subject losses should be disallowed because the instant transactions were factual shams:

1. *Allowance of LMEI/LMEC*

(a) *Correlation of tax needs and losses*

All of the losses in issue resulted from transactions entered into between petitioners and one of two corporate entities located in London. As we have found, the first such corporation, LMEI, was founded in 1972 by Paul Martin and James Gourlay. The second corporation, LMEC, was owned by Gourlay.

In 1980, Paul Gleeson, who was an employee of LMEI, met Robert Ketron, who was at that time a professional geographer with no experience in commodity trading, and invited him to observe the operations of his company in London. After his return, Ketron formed a corporation named InterAct Trading Corp. for the self-described purpose of providing informational services concerning metals trading in foreign markets.

In November of 1980, at Ketron's request, a certified public accountant named Robert Warshawsky traveled to London to evaluate LMEI. While Warshawsky's visit failed to provide him with any basis to evaluate the bona fides of LMEI's forward trading in gold and platinum, his formal report included the observation that the company was not especially qualified to trade in those metals "by virtue of experience or expertise."

InterAct subsequently agreed to refer investors to LMEI, in exchange for an even split of all commissions. Notwithstanding Warshawsky's foregoing admonition, InterAct's financial advisers referred each of the petitioners herein, with the exception of Bramblett, to LMEI for the purpose of opening accounts for trading in gold and platinum forward contracts.

As we have found, American investors, including all petitioners except Bramblett, were referred to LEMI/LMEC through a network of financial advisers employed by InterAct. Each such adviser, and an undisclosed number of investors themselves, were provided by InterAct with an information package relative to opening a trading account with LEMI/LMEC. The information provided by InterAct included extensive tax advice on both reporting losses from commodity transactions, including appropriate form exemplars, and dealing with audits by the Internal Revenue Service.

Also included in the InterAct information package was a recommendation that investors authorize InterAct to prepare a computer analysis of their estimated "future income," "taxable income," "tax liability," and "projected results of an investment in a trading account." This record does not clearly disclose whether each petitioner was apprised of and/or adopted this recommendation. However, in some instances, petitioners' InterAct advisers were also their regular financial advisers or their accountants who also prepared their tax returns for them. Avery Klein, in whose nominee account petitioner Mahoney had invested, was an accountant for the founder of InterAct, Robert Ketron. Petitioner Wooldridge testified that he started his tax planning at the beginning of each year, and that at such times he met with his InterAct adviser at least monthly. Petitioner Enrici testified that his InterAct adviser knew that he had large capital gains in 1980. Each investor was also required by InterAct to have a taxable income of at least $50,000, and assets worth at least $200,000. As stated by Ketron, "we weren't asking people who made $15,000 a year with $500 in the bank to send their hard-earned dollars to London."

Taking these facts together with InterAct's foregoing recommendation, we believe that an inference may fairly be drawn that InterAct, through its agents, was generally aware of its clients' projected income and tax liability for the years in issue.[31]

Significantly, InterAct provided its advisers, and at least some of its investors, with detailed information concerning the quality and amount of losses which an investment in LEMI/LMEC could be expected to generate. Thus, during the years in issue, either of two basic techniques was allegdly employed by LEMI/LMEC to dispose of loss contracts, viz, cancellation or offset. In a document styled "Investment Criteria of Forward Contracts," which was included in its information package, InterAct provided advice, replete with legal citations, that the closing of a forward contract by *cancellation* would not constitute a sale or exchange, and would therefore give rise to ordinary gain or loss. In another document styled "Advisor Information Sheet," InterAct purported to show the "possible tax deductions" which could be achieved in 1980 for certain specified amounts of cash margin and advisory fees. According to this document, the cash margin requirements would increase with increasing levels of posible tax deductions, and for any given amount of such deductions, the margin requirements would increase on certain dates, as accounts were opened closer to the end of the year.

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[31] Bramblett, who did not use the services of InterAct, testified that it was "possible" that LMEI/LMEC learned of his income status in 1980 through the individual who prepared his tax return, who was also an investor in LMEI/LMEC.

As reflected in table 5, each petitioner except Enrici reported a significant amount of ordinary income but a relatively small amount of capital gains in 1980. With the losses from LEMI/LMEC trading reported in 1980 (table 3), petitioner Forseth was able to offset almost all of his gross income, petitioner Bramblett was able to offset almost exactly his substantial wage income, and petitioner Easterling was able to offset almost exactly his substantial business income. As shown on table 6, each petitioner was able to offset a substantial portion of his adjusted gross income, in percentages ranging from 55 to 94 percent, and averaging 72 percent. The losses for each such petitioner were generated by closing forwards positions by cancellation, and in accordance with InterAct's foregoing advise, were reported as ordinary losses.

Furthermore, petitioners Enrici, who were able to utilize their LEMI/LMEC losses to reduce their adjusted gross income in 1980 by some 83 percent, were unique among petitioners herein in facing a relatively large amount of capital gains in that year. Acting in a manner which was unique among the accounts described herein, LEMI/LMEC utilized its discretionary trading authority to close the Enricis' contracts, not by cancellation, but by offset. Unlike the other petitioners, the Enricis then reported capital losses which substantially offset their capital gains for 1980.[32]

It is interesting to note, by way of contrast, in each of the five instances in which accounts had been closed as of the time of the trial in this matter, and wherein petitioners would presumably prefer capital to ordinary *gains*, the gain sides of petitioners' straddles were closed by methods other than cancellation.

The foregoing considerations suggest remarkable correlation between the tax needs of each petitioner during the years in issue and the nature and amount of tax losses delivered by LEMI/LMEC and InterAct. It should be noted that this is not a situation where losses inherent in the loss legs of petitioners' straddles at the end of 1980 greatly exceeded the income which they could offset in that year resulting in their selective closure of certain positions so as to maximize their tax benefit in that year. Rather, with the exception of the Enrici account, LEMI/LMEC closed *all* of the loss positions in a single metal in petitioners' gold and platinum trading accounts during the years in issue, with results which were surprisingly responsive to their individual tax needs in those years.

(b) *InterAct's prediction of tax losses*

We have found that InterAct produced and distributed an Advisor Information Sheet which projected "possible tax deductions" which could be expected at various levels of margin deposit. For unexplained reasons, the Advisor Information Sheet shows margin requirements increasing as the end of 1980 approaches. While such increasing requirements bear no apparent relationship to the exposure of LMEI/LMEC in the marketplace, they do appear to relate to the diminishing time within which the company could put on straddle positions, and then liquidate the loss legs during petitioners' 1980 tax years.

This record does not reflect whether LMEI/LMEC adhered to the margin requirements shown on InterAct's Advisor Information Sheet. It also does not clearly reflect either the dates on which petitioners first opened their accounts with LMEI/LMEC, or whether the "accounts through * * * " dates on such

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[32] As we have found, the Enricis utilized principally their LEMI/LMEC losses to reduce their long-term capital gains of $1,991,748, to a net gain of only $249,817, of which $99,927 was reported as taxable.

Sheet refer to the dates on which accounts were opened with LMEI/LMEC, InterAct, or otherwise. We therefore cannot determine with certitude which cash margin deposits' schedule from the Advisor Information Sheet might have applied to each petitioner herein. At a minimum, however, the losses actually delivered by LMEI/LMEC to petitioners in 1980 were generally within the range of the "possible tax deductions" projected by InterAct for various levels of margin deposit, and remarkably, as demonstrated in the following table, when the figures for "accounts through November 1, 1980," are used,[33] the losses projected by InterAct were right on target:

	Adviser information sheet		*Actual margin and losses*	
Account	*Margin required*	*"Possible tax deductions"*	*Net margin posted* (table 2)	*1980 losses reported*
Forseth	$6,250	$50,000	$6,250	$50,400
Formsma	10,000	80,000	10,000	80,500
Klein	25,000	200,000	25,500	230,100
Bramblett	12,500	100,000	15,000	121,300
	25,000	200,000		
Wooldridge	6,250	50,000	8,375	66,500
	10,000	80,000		
Easterling	12,500	100,000	22,500	177,600
	25,400	200,000		

As to Avery Klein's nominee account, of the total margin posted, petitioner Mahoney had paid $6,250 prior to October 31, 1980. Pursuant to the Advisor Information Sheet, a margin deposit in this amount could yield a tax deduction of $50,000 in 1980. For 1980, Mahoney claimed losses from his LMEI/LMEC trading in the amount of $50,022.

It therefore would appear that petitioners' losses were not only remarkably responsive to their tax needs in 1980, they were also predictably so.

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[33] The record does reflect that the Klein margin deposit, which included Mahoney's $6,250 share, was transmitted to LMEI/LMEC on Oct. 31, 1980, and that petitioner Forseth opened his account in late Fall of 1980.

(c) *Margin requirements: LMEI/LMEC's "insurance against risk"*

According to petitioners, LMEI/LMEC was at all times protected against the possibility of default on the part of any of its American investors. Such protection was purportedly provided by the company's margining requirements, which were its purported insurance against risk. As stated by Gleeson, "if a client, even though [he] may be an honorable gentleman, does not perform in his debt situation, then we are holding some collateral to cover that eventuality."[34]

Consistent with the professed importance of margin deposits to LMEI/LMEC it was the policy of the company, as described by Gleeson, not to begin trading until sufficient margin was received *unless* the client was referred by an existing client who *guaranteed* that any losses sustained on the account of the new client would be covered. However, LMEI/LMEC actually commenced alleged trades prior to posting margin deposits for each of the accounts in issue, with the exception of the account of Avery Klein, as follows:

Account	*Initial margin posted (table 2)*	*Trading begun (table 4)*
Forseth	12/31/80	12/30/80
Formsma	12/22/80	12/12/80
Bramblett	12/31/80	12/22/80
Enrici	12/29/80	12/18/80
Wooldridge (1980)	12/15/80	12/09/80
Wooldridge (1981)	12/02/81	06/16/81
Easterling	12/29/80	12/05/80

As to petitioner Forseth, we have found that he transmitted his margin deposit for 1980 by wire from his bank account in Wisconsin to a bank in Paris on December 30, 1980. The record does not reflect why the margin deposit for a London corporation allegedly trading in a London market was transmitted to

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[34] While Gleeson, at one point describing the LMEI/LMEC margining system as "totally arbitrary," emphasized that this was the customary "system of margining in England," we find such uncorroborated testimony to be inconsistent both with the testimony of petitioners' own witness, Robert Warshawsky, who had inspected and reported on the LMEI/LMEC operations at the behest of Robert Ketron, to the effect that "there was some competitive pressure to keep the margins at the one-eighth to one-fourth percent level which was customary," and with Gleeson's own testimony concerning the importance of sufficient margin to the protection of his company from risk.

Paris, but given the 7-hour time difference between Wisconsin and Paris, it could not have been credited to the Paris account much before the close of the banking day on December 30, 1980, and it was not posted with LMEI/LMEC until the following day. Even with this limited time, LMEI/LMEC was still apparently able to conduct its competitive search for a market-making broker, to establish a gold/platinum straddle, and to "lay it off" to Forseth, in the manner described *infra*, all on *December 30, 1980* (table 4), prior to the posting of his margin deposit. With comparable alacrity, the corporation canceled Forseth's short position in platinum on the following day (table 4), at a loss which offset almost all of his gross income for that tax year.

On December 5, 1980, petitioner Easterling received a letter from LMEI/LMEC, stating as follows:

> We are pleased to hear from our telephone conversation that you have forwarded to us a cheque in the amount of $27,000.00. We look forward to trading with you and hope that we will have a long and prosperous association.

Despite the foregoing language, Easterling's trading authorization was only executed on December 7, 1980, and his margin check was only drawn on December 17, 1980, and posted with LMEI/LMEC on December 29, 1980. Nevertheless, LMEI/LMEC began trading for Easterling on the date of his foregoing letter, and actually canceled his loss positions for 1980, on December 12 and 16 of that year (table 4). While LMEI/LMEC therefore did not have to "look forward to trading" with Easterling for very long (i.e., on the same day), his 1980 trading losses offset 91 percent of his adjusted gross income, making his 1980 association with that company very "prosperous" indeed.

Similarly, in the case of petitioner Bramblett, his long platinum position entered into on December 23, 1980, was canceled on December 30, 1980, one day prior to the posting of his margin deposit with LMEI/LMEC (table 4).

Contrary to Gleeson's testimony, therefore, it is clear that contracts were entered into and positions were even canceled at a loss anywhere from 1 day to over 5 months before certain petitioners had posted any margin with LMEI/LMEC, and in one case, 2 days before petitioner had executed his trading authorization. In light of Gleeson's testimony that commodity trading was "a highly risky business [in which] unfortunately statistics show that 90 percent of all commodity speculators lose money," and that the ratio of gold to platinum forward contracts prices during the years in issue was "fairly volatile," we find it highly unlikely that a company undertaking bona fide trades in gold and platinum forward contracts for the accounts of its investors would accept this type of exposure.

It is true that Robert Ketron testified that either the InterAct adviser or InterAct, itself, would be liable for any margins which were not paid to LMEI/LMEC by its clients. Furthermore, Gleeson, testifying that he had confidence in InterAct and that InterAct would back up its client's commitments that margin deposits were in the mail, indicated that LMEI/LMEC also withheld a pool of funds from amounts which were credited to InterAct relative to its 50/50 commission-sharing arrangement with LMEI/LMEC, and that such funds represented a "contingency against * * * this event of a check not turning up or * * * a loss incurred."

We are not persuaded, however, that LMEI/LMEC was protected against the risks of investor noncompliance by virtue of its relationship with InterAct. First, it is undisputed that petitioner Bramblett invested in LMEI/LMEC without utilizing the services of InterAct or its advisers, and there is no evidence that he was referred by an existing client who guaranteed any losses sustained on his account. Despite the apparent absence of any insurance against risk, LMEI/LMEC began trading for Bramblett's account 1 day prior to the date of his margin deposit check and some 9 days prior to the posting of such deposit in London. Second, there is not a shred of documentary evidence in this record to substantiate the foregoing self-serving testimony of Ketron and Gleeson that InterAct had guaranteed the payments of its client-investors. Third, there is no persuasive evidence that LMEI/LMEC had any reason to believe that InterAct or its financial advisers had the financial capacity to perform under its purported guarantee or that the alleged pool of withheld commissions would be sufficient in the event of the failure of one or more of its client investors, assurances which would surely have been essential to any broker not wishing to be at risk in a real marketplace.

Consistent with his testimony that investor margin constituted LMEI/LMEC's insurance against risk, Gleeson also testified that the corporation's computers produced a daily "open position report" to assure that investors always had adequate margin in their accounts. Such reports, Gleeson testified, summarized trades, identified all open positions, and estimated the value of such positions. If margin was found to be depleted as a result of unrealized losses in an account, according to Gleeson, "We would close the position out, or we would inform the client that his money was depleted and did he wish to put up some more money."

As we have found, however, none of the subject accounts was ever subject to a margin call and no petitioner-investor ever posted any additional margin. According to respondent's agent, Fred Swinford, who was a "job coach" for commodity tax shelter specialist training and national coordinator of the so-called "LME tax shelter project," in 160 cases he had reviewed in such capacity, all of which involved investors in LMEI/LMEC, there had never been a margin call. It was Gleeson's testimony that no margin calls were made in the instant cases simply because, in his discretion, "the people did not exceed their margins."

During the years in issue, as we have found, neither gold nor platinum was traded on any exchange in London and no prices were published in London for forward contracts in those metals. Furthermore, petitioners had no way of verifying the prices at which LMEI/LMEC conducted transactions on their behalf. However, we have found that forward contracts in gold and platinum were traded on the ABT in New York, which regularly published its spot and 1- to 12-month forwards prices in the Wall Street Journal.[35]

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[35] Respondent has entered into evidence herein, and both parties have argued extensively on brief, the results of his comparisons of the instant transactions with *futures trading* in the same metals on certain recognized American exchanges, for which prices are published in the Wall Street Journal (and were stipulated into evidence herein). However, respondent's agent, Fred Swinford, acknowledged at trial that in view of certain differences between regulated and unregulated markets, the price of a forward contract on an unregulated market may not be the same as the price of an otherwise comparable futures contract on a regulated exchange. Petitioners thus urge that respondent is comparing "apples and oranges." We agree, and since we are convinced that such a comparison of apples and oranges, and a fortiori, English apples and American oranges, would not be a probative exercise, we have decided the instant cases without regard to such evidence. However, respondent also entered into evidence, herein, certain comparisons of the instant transactions with *forward trading* in the same metals on the ABT exchange. We are mindful that such evidence constitutes a comparison, in essence, of English apples and American apples. However, we are prepared to accept the limited probativity of this comparison (with modifications which are embodied in our table 9 to correct certain computational errors), first, because of the price-leveling effects of arbitrage, which are discussed in our findings;

As indicated on table 9, assuming that petitioners had liquidated their gold and platinum positions at ABT's published gold and platinum forwards prices for certain dates between January 29, 1981, and February 1, 1982, as interpolated to comparable delivery dates, the 1980 account of each petitioner, except Easterling, would have at various times reflected negative equity balances. While we do not assume that the figures in table 9 would necessarily reflect the exact equity in similar forward contracts traded in a bona fide London market, we do believe that such figures suggest the improbability of the notion contended for by petitioners, that their accounts *at no time* reflected negative equity balances which would give rise to the need for margin calls.

(d) *Zeroing-out of account balances*

We have found that the margin balances in the 1980 accounts of the four petitioners whose accounts were closed as of the time of the trial in this matter, as shown on table 2, were roughly equal to the excess of their 1980 losses over their 1982–84 gains, as shown in tables 7 and 8.

On December 31, 1980, petitioner Bramblett posted his initial margin deposit of $15,000 (table 2). On that day and the preceding day, Bramblett's loss positions were canceled for total losses in the amount of $121,300 (table 4). Over 3 years later, Bramblett's six open gold positions, which had been rolled forward to March of 1984, were closed by offset, for a gain of $106,280. With the closing of his accounts, Bramblett had realized a net loss only $70 in excess of the amount of his initial margin deposit (table 8). As of the time of the trial in this matter, LMEI/LMEC had not collected this sum from Bramblett.

On December 15, 1980, petitioner Wooldridge posted his initial margin deposit of $10,000 for his 1980 account, and *on the same day*, $1,625 of that deposit was transferred by LMEI/LMEC to an unrelated trading account, leaving a net margin of $8,375. On December 12 and 16 of 1980, Wooldridge's loss positions were canceled for total losses in the amount of $66,500 (table 4). Over 3 years later, Wooldridge's four open

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second, because of the absence of any other meaningful basis upon which to evaluate the bona fides of the unpublished LMEI/LMEC pricing structure; and third, because of petitioners' failure to prove any error in accepting such a comparison.

gold positions, which had been rolled forward to February and March of 1984, were closed by offset, for a gain of $58,320. With the closing of his 1980 account, Wooldridge had realized a net loss only $195 less than the amount of his initial margin deposit, as adjusted on the same day it was posted (table 8).

On December 22, 1980, petitioner Formsma posted his initial margin deposit of $19,000 (table 2). On December 23 and 24 of 1980, Formsma's loss positions were canceled for total losses in the amount of $80,500 (table 4). Some 2 weeks later, $9,000 of Formsma's margin deposit was transferred by LMEI/LMEC to an unrelated trading account, leaving a net margin of $10,000. Some 18 months later, Formsma's six open platinum positions were sold to an alleged entity known as Broadstreet Investments, for a gain of $70,500. With the closing of his account, Formsma had realized a net loss exactly equal to the amount of his initial margin deposit, as adjusted only 2 weeks after it was posted (table 8).

On December 29, 1980, petitioner Easterling posted his initial margin deposit of $27,000 (table 2). As discussed *supra*, Easterling's loss positions had already been placed and then canceled by LMEI/LMEC some 2 weeks earlier on December 12 and 16 of 1980, for total losses in the amount of $177,600. Approximately 1 week after the posting of his initial margin, $4,500 of Easterling's deposit was transferred by LMEI/LMEC to an unrelated trading account, leaving a net margin of $22,500. Some 13 months later, Easterling's six open gold positions were sold to the same Broadstreet Investments, for a gain of $155,100. With the closing of his account, Easterling had realized a net loss exactly equal to the amount of his initial margin deposit as adjusted only 1 week after it was posted (table 8).

Given the purported volatility of the gold and platinum markets during the years in issue, the petitioners' acknowledgement on brief that after the gold/platinum straddles held by most petitioners had been converted to a straddle in one metal, they "continue[d] to have a potential to make or lose money," we do not believe that any broker in a real commodities market could so nearly predict in 1980 and early 1981, the amount of the excess of an investor's 1980 losses over his eventual gains on straddle positions closed some 2 to 4 years later. We find this apparent prescience especially remarkable in the cases of petitioners Bramblett and Wooldridge, whose margin accounts were never adjusted after the day on which their initial margin deposits were posted. We also find it curious that the record is devoid of any credible third-party evidence to corroborate the existence or alleged role of Broadstreet Investments, yet in the only two instances where accounts were closed by purported sales of open positions to that entity, the accounts of petitioners Formsma and Easterling were zeroed-out with mathematical precision.[36]

Only in the case of the fifth closed account, the Avery Klein nominee account, was there a significant balance after all positions were closed out in or about February of 1982, in the deficit amount of $15,360. For this account, the LMEI/LMEC trading records disclose that a credit entry was made on March 3, 1983, in the amount of $15,290, leaving a deficit balance of only $70. The credit entry is described as "Journal From Related A/C," and is otherwise unexplained in any of the trading documentation. The Klein account is one of two accounts for which Gleeson said that he left the LMEI/LMEC backup workpapers behind in London. At trial, Klein explained the entry as follows:

> I don't know. LME made that entry. I am assuming they just transferred it between my two accounts, not knowing that they were separate people who were involved in them. I had a great deal of problem trying to get the bookkeeping straightened on these two accounts with them. When I finally ended up with a reconciliation from them late last year, they had again combined all the accounts on the reconciliation—or both these accounts.

Klein thus attributed the $15,290 credit entry to a bookkeeping error on the part of LMEI/LMEC. However, each of Klein's accounts was held on behalf of a wholly different group of investors. Any such "bookkeeping" error would thus have the effect of increasing the equity in the loss account of one group of investors at the expense of reducing the equity in the profit account of a separate group of investors. Klein testified that he called LMEI/LMEC in an attempt to reconcile the accounts, but there is no evidence that he or any of the investors wrote to

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[36] We note that respondent's agent, Fred Swinford, testified that he received and reviewed worksheets from other revenue agents relative to more than 160 other cases involving LMEI/LMEC commodity straddles, from which he could and did determine the losses claimed in 1980 and 1981. In all such accounts which were closed as of the time of his review (the number of which is not disclosed), the account balance was either zeroed-out, or very nearly so.

LMEI/LMEC, sought any legal advice, or threatened legal action against the London company.

We find it highly unlikely that either the investors in Klein's profit account or their nominee, who was a certified public accountant, would be so tolerant of such a grave accounting failure for a period beginning in early 1982 and continuing at least into late 1983. Moreover, Klein testified that he received from LMEI/LMEC and distributed to the investors in *both* of his nominee accounts the total margin balance of $469, which allegedly remained in the accounts after they were closed. How the deficit balance in the loss account could properly become a credit balance justifying such a distribution remains a mystery on this record.

(e) *"Laying-off" trades*

Gleeson testified that he would enter into the transactions in issue in the following manner: First, he contacted by telephone four or five brokers who were "making markets" in forward positions in gold and platinum, which LMEI/LMEC did not do, and asked for prices on gold-platinum spreads for specified delivery dates. Each broker would quote a bid and an asked price, which were typically about $0.50 apart, per troy ounce. According to Gleeson, the prices quoted "had to be right on the market," since he could trade the full spread or, if they were not, separately trade either position therein with another market-making broker. The market-making brokers charged their clients a commission for their services. After LMEI/LMEC had purportedly established a gold-platinum straddle with the market-making broker, its policy was to avoid being at any risk in the market by immediately "laying-off" its positions; that is, using its discretionary trading authority to take opposite positions with the investor for whom the straddle was executed. For example, if LMEI/LMEC was short in gold and long in platinum with the market-makers, it would go long in gold and short in platinum with the investor, whose positions, in turn, would be short in gold and long in platinum.

In addition to the protection against investor default purportedly provided by the LMEI/LMEC margining system, therefore, since that company's purported trades in gold and platinum forwards positions were on a principal-to-principal basis in an informal telephone market, its stated policy was to avoid being at risk by immediately "laying-off" its positions with its investors, including petitioners herein. At trial, Gleeson described the foregoing process as follows:

> Q. * * * My question is directed to how [LMEI/LMEC] or any commodities firm similarly situated avoids being at risk in the market itself.
>
> A. * * * there are two sorts of traders in London. One is a dealer, and the other is a broker. A dealer will take positions himself and gamble that he is making the right choice. A broker, as we are, will always lay off those positions, i.e., find another party to take the risk.
>
> Q. And how does the other party take the risk?
>
> A. Well, if, for instance, [you] had bought from me, I would buy from somebody else, and I would act as a broker in the middle and pass that deal on to the other party. But I would not be exposed.
>
> Q. So you are saying that if [LMEI/LMEC] took a long position in gold with one person, that they would then take an offsetting short position with some other person?
>
> A. Correct, yes.

It would appear that in order to be fully insulated from risk, LMEI/LMEC would have to lay off its positions with opposite positions *for the same delivery date*. Unexplained on this record is why the laying-off of a contract in this manner would not cause the contract to be closed out by offset. In any event, as conceded by Gleeson, under the brokerage scheme described, LMEI/LMEC stood to make money purely on its brokerage commissions, and the company had no opportunity to make money and no risk of losing money in response to price fluctuations in the gold and platinum forwards market.[37]

Essential to the position of LMEI/LMEC in the foregoing process was the establishment in the first instance of long or short forward positions with the market-making brokers, and then the immediate laying-off of such positions with their investors. While petitioners produced extensive internal documentation of their alleged "laid-off" trades, however, this record is conspicuously devoid of any evidence, documentary or otherwise, to corroborate Gleeson's testimony that opposite positions were always first entered into with the market-making brokers. Petitioners failed even to identify the supposed market-makers with whom LMEI/LMEC allegedly dealt.

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[37] For gold and platinum straddles, according to Gleeson, the commissions were generally $0.50 per troy ounce of metal traded plus the costs of placing the trades with the market maker, and they were built into the contract prices of the trades with the investors, rather than separately stated.

This failure is especially surprising in light of Gleeson's testimony that the oral trades with market-making brokers were *always* confirmed in writing. Since the existence of competitive market-making trades would serve not only to insulate LMEI/LMEC from risk, but also to establish prices in the alleged market in which petitioners' positions were established, we find petitioners' complete failure to produce the foregoing corroborative evidence suggestive of the artificiality of such pricing and indeed of such market. See *Julien v. Commissioner*, 82 T.C. 492, 503 (1984).

(f) *Manipulation of trading records*

Further suggestive of the artificiality of the subject market is the apparent manipulation by LMEI/LMEC of certain trading documentation relative to petitioner Wooldridge's 1981 account.[38] Included in the trading records for such account are typed debit notes reflecting charges in the amounts of the losses claimed by Wooldridge in that year for the cancellation of three contracts which are described as having been entered into, as shown on table 4, on June 16, 17, and 19 of 1981. According to petitioners, these contracts were canceled, as reflected on the debit notes and shown in table 4, in early July of 1981. However, according to two computer-generated forms styled "Statement on Account on Closed Positions" which are also included in the trading records, the instant contracts were canceled, not in July of 1981, but in October of that year.

We have found that the October cancellation dates are shown on two separate account statements, dated several years apart. Based upon the Testimony of Paul Gleeson, we have also found that these statements were generated by LEMEI/LMEC's own computers, but that the debit notes were manually typed. At trial, Gleeson contended that it was the account statements which bore erroneous dates, and attributed this to "clerical error." We find it more plausible, however, particularly since this was the second account as to which Gleeson stated that he "left behind" in London LMEI/LMEC's backup worksheets, that the dates on the manually prepared debit notes were manipulated.

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[38] See *Ostrower v. Commissioner*, T.C. Memo. 1984-496.

For positions *established* after June 23, 1981, the apparently favorable consequences of tax straddling were eliminated by Congress in section 1092(a) added by the Economic Recovery Tax Act of 1981, Pub. L. 97–34, sec. 501(a), 95 Stat. 323, pursuant to which losses from straddles are essentially disallowed except to the extent that they exceed unrealized gains on the offsetting positions comprising the straddle. While it is therefore clear that the dates on which Wooldridge's purported 1981 contracts were established rather than on the dates on which they were canceled would determine the applicability of section 1092(a), we believe that it is probable that the cancellation dates on the debit notes were changed so as to make the pre-June 23, 1981, establishment dates less subject to question.

(g) *Conclusion*

This Court has previously recognized that an alleged commodity straddle will not be recognized for Federal tax purposes where the underlying transaction is a sham. *Julien v. Commissioner, supra*. Section 165(a) requires that in order to be deductible a loss must be "sustained during the taxable year." The regulations under section 165(a) provide that "To be allowable as a deduction * * *, a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and * * * actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss." Sec. 1.165–1(b), Income Tax Regs. See *Gregory v. Helvering*, 293 U.S. 465 (1935). As noted recently by the Seventh Circuit in *Saviano v. Commissioner*, 765 F.2d 643 (7th Cir. 1985), affg. 80 T.C. 955 (1983):

> The freedom to arrange one's affairs to minimize taxes does not include the right to engage in financial fantasies with the expectation that the Internal Revenue Service and the courts will play along. The Commissioner and the courts are empowered, an in fact duty-bound, to look behind the contrived forms of transactions to their economic substance and to apply the tax laws accordingly.

Petitioners bear the burden of proving that the transactions actually occurred as claimed. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); Rule 142(a).

In the instant cases, LEMEI/LMEC entered into alleged commodity straddles on behalf of each petitioner in the final 2 months, and in some instances, on the final day of their 1980 tax years.[39] Petitioners needed certain losses in 1980, and InterAct suggested that it could deliver them by placing "trades" through LEMEI/LMEC in its overseas principals market. The role of LEMEI/LMEC in this scheme was cast as that of a neutral broker, standing to make money solely on commissions, but insulated by its margining requirements and its practice of "laying-off" all trades from the vicissitudes of a purportedly risky and volatile marketplace. Viewed in light of all of the evidence, however, this role quickly evaporates, suggesting that the real role of LEMEI/LMEC was to contrive and/or manipulate an unregulated and unpublished market in gold and platinum forward contracts so that it could deliver to its investors the losses promised by its fee-splitting American liaison, InterAct.

After a careful review of the facts, we must conclude that the transactions before us were factual shams, inspired, designed, and executed by LMEI/LMEC, with the participation of InterAct, for the sole purpose of achieving for its investors capital and ordinary losses to offset their unrelated income in 1980 and 1981. Petitioners have failed to prove that there was any actual gold or platinum, that there was any real market or trading, or that there was any purpose, other than the avoidance of taxes, for any of the transactions in issue.[40] We therefore uphold respondent's disallowance of petitioners' loss deduction[41] and, in the cases of petitioners Formsma, Mahoney, Enrici, Wooldridge, and Easterling, deductions for purported advisory fees paid to InterAct.[42]

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[39] For reasons which we have already discussed, we do not really know when the 1981 trading documentation for Wooldridge was generated.

[40] As we have found, in the case of petitioner Forseth, the claimed ordinary loss was not allowed as an ordinary loss, but a short-term capital loss of $1,500 was allowed. Since disallowance of the capital loss was an issue first affirmatively raised by respondent in his answer, we ruled at trial that he had the burden of proof on this point. Rule 142(a). Respondent has met that burden.

[41] Petitioners make much of the reputation of Rudolf Wolff & Co., with whom the founders of LMEI, Martin and Gourlay, and Paul Gleeson were at one time associated. We therefore note that while Rudolf Wolff & Co. was in London brokerage firm dealing in commodity transactions on the well-recognized London Metal Exchange, in *Julien v. Commissioner*, 82 T.C. 492, 506–508 (1984), this Court also found that the same company, together with a corporate affiliate, was a party to a prearranged cash and carry silver transaction which represented a "grotesque distortion of the orthodox commodity straddle" (*Julien v. Commissioner, supra* at 508), and which was not entitled to recognition for Federal income tax purposes. See also *Hirai v. Commissioner*, T.C. Memo. 1984–495. Compare *Mortensen v. Commissioner*, T.C. Memo. 1984–600. In any case, Rudolf Wolff & Co. appears to have had nothing to do with the matters here in dispute.

This result is not changed by section 108 of the Tax Reform Act of 1984. As this Court has found, that section only applies to straddles actually acquired by a taxpayer during the pre-1982 period, and not to alleged straddles which are, in fact, fake or fictitious. *Miller v. Commissioner*, 84 T.C. 827 (1985). See also sec. 1092(c); *Forseth v. Commissioner*, T.C. Memo. 1985–279.[43]

2. *Negligence*

We turn finally to the additions to tax for negligence. Under section 6653(a), if any part of an underpayment of income tax is due to negligence or intentional disregard of rules and regulations, there shall be added to the tax an amount equal to 5 percent of the underpayment. Respondent determined additions to tax for negligence against petitioners Forseth, Formsma, Bramblett, and Easterling relative to their 1980 tax year.[44] As to such determinations, petitioners bear the burden of proving error. *Enoch v. Commissioner*, 57 T.C. 781 (1972). In each case, we are persuaded on the facts that petitioners have failed to meet that burden.

We find it highly significant that each petitioner executed a written document authorizing LMEI/LMEC to trade on his behalf on a discretionary basis *without any dollar limitation*. Forseth, Formsma, and Easterling testified that they never told LMEI/LMEC how much they were prepared to lose. Forseth testified that he anticipated earnings of $10,000 from a land sale, and it was solely this sum that he intended to invest in LMEI/LMEC, yet he at no time communicated this limitation to the London company. With dubious hyperbole, Bramblett testified that he realized that he could be "wiped out financially" by virtue of his LMEI/LMEC trading activity. Petitioner Easterling, by contrast, concluded that he was only risking a little over $200,000 on his $27,000 investment for the reason that "they could leverage you as much as eight to one." On this record, however, it is clear neither what Easterling meant by this nor how he might have been assured thereby that his losses would be so limited.

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[42] On the issue of the disallowance of fees to InterAct, respondent had the burden of proof as to petitioner Easterling. See note 4 *supra*. Rule 142(a). Respondent has met that burden.

[43] Having decided that the instant transactions were factual shams, we need not, of course, reach petitioners' additional argument that they were entered into for profit, or respondent's alternative argument that any losses allowed should be capital rather than ordinary in nature.

[44] According to respondent, his failure to determine additions to tax against the remaining petitioners was due to an "oversight."

As we have found, petitioners Forseth and Easterling had at least some prior exposure to trading in commodities, and petitioner Bramblett had invested in the stock market for more than 20 years. Despite this experience and their apparently unlimited exposure, however, all four petitioners were remarkably oblivious to the operations of LMEI/LMEC. Forseth was totally unaware of the company's procedures. Neither Bramblett nor Formsma knew how LMEI/LMEC computed its margin requirements; they merely sent in what they were told to send. Formsma admitted that he did not know whether InterAct or anyone else was monitoring his account after he had opened it and trading had begun. None of the four petitioners was aware how the London company computed the alleged losses or the prices at which his positions were liquidated. Bramblett just "assumed" they were "honest people." Despite Easterling's lack of awareness concerning LMEI/LMEC's computation of his losses, when asked why he had not invested in a regulated, domestic futures exchange instead, he professed a confidence in the London company which we find dubious and groundless, as follows:

> I knew of no other trading market in the United States that might have the expertise that the people in London would have—and hopefully the ability to exercise orders more quickly and more knowlegeably [sic].

While the four petitioners claimed that they followed the advice of their tax and financial advisers and InterAct promoters, persuasive evidence of any real research into the reputation and trading activities of LMEI/LMEC, or of any reasonable basis to support their alleged reliance on such advice is wholly lacking on this record.

Finally, we are persuaded that all four petitioners, at a minimum, acquiesced in the adoption by their 1980 return preparers of certain instructions for reporting losses from their transactions with LMEI/LMEC in such a way that the nature of such losses would be obscured. This conclusion results, first, from the similarity of the language used by each petitioner to report such losses to the exemplary language provided in the InterAct information packet, neither of which makes reference to LMEI/LMEC or the unregulated, overseas exchange on which the cancellations purportedly occurred;[45] and second, from the failure of each petitioner to check the "yes" box in response to the foreign account question on Schedule B of his 1980 return. Moreover, at least as to the three petitioners who utilized the services of InterAct, our conclusion is strengthened by Ketron's frank admission at trial that "we educated [clients] regarding the way that we understood the way certain profits or losses could be reported."

In view of the foregoing considerations, we sustain respondent as to the additions to tax for negligence.

To reflect the foregoing,

Decisions will be entered under Rule 155.[46]

THOMAS S. AND BARBARA EANES, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 30611–84. Filed July 30, 1985.

Petitioner participated in his employer's qualified retirement plan during 3 months of employment in 1981. Upon termination of employment, petitioner irrevocably forfeited all rights in the retirement plan. If he were reemployed by the company, he would receive no credit for prior contributions and would be treated as a new employee for plan purposes. Petitioner subsequently contributed $1,500 to an Individual Retirement Account (IRA) in 1981 and deducted that amount on his Federal income tax return. Respondent disallowed the IRA deduction and sought to impose an excise tax under sec. 4973, I.R.C. 1954. *Held*, that the IRA contribution is not deductible under sec. 219(a) because petitioner was an "active participant" in a qualified plan for the year 1981. *Hildebrand v. Commissioner*,

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[45] In this regard, it is interesting to note that Bramblett did not use the services of InterAct.

[46] While we have found for respondent on all issues before the Court, certain stipulated concessions by respondent concerning the method of computing petitioners' tax liabilities and respondent's pleadings for increased deficiencies in a number of cases, call for entry of our decision under Rule 155.

683 F.2d 57 (3d Cir. 1982), followed. *Held, further*, excise tax imposed.

Thomas S. Eanes, pro se.
Lynn L. Casimir, for the respondent.

PANUTHOS, *Special Trial Judge*: This case was heard pursuant to the provisions of section 7456(d) of the Code.[1]

Respondent determined a deficiency of $474.10 in petitioner's[2] 1981 Federal income tax. The issue for decision is whether petitioner is entitled to a deduction of $1,500 for a contribution to an Individual Retirement Account (IRA).[3]

At the time of filing his petition, petitioner resided in Alameda, California. Some of the facts have been stipulated and are incorporated herein by this reference.

FINDINGS OF FACT

Petitioner was employed by Tudor Engineering Co. from November 3, 1980, through March 27, 1981. Throughout 1980 and 1981, the company maintained a retirement plan based on profit-sharing. Petitioner, as an employee of the company, was eligible to participate in the plan.

From January through March 1981, petitioner made voluntary contributions to the plan. His contributions totaled $181.10. This amount was refunded to him in March when he terminated his employment with the company.

Under the terms of the company's retirement plan, 1 year of service is a fiscal year during which an employee is credited with at least 1000 hours of service. A one-year break in service occurs if an employee is credited with less than 500 hours of service for a fiscal year. This determination is made as of December 31. When an employee terminates his employment during a plan year and incurs a 1-year break in service, the employee forfeits any nonvested employer contributions. These contributions are then distributed to the accounts of the remaining participants. An employee's own contributions are returned to him. As the plan existed in 1981, if an employee were subsequently reemployed after a 1-year break in service, he would be treated for purposes of the plan in the same manner as any new employee because he had previously irrevocably forfeited his non-vested rights in the plan.

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[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise indicated.

[2] We will refer to Thomas Eanes as petitioner.

[3] In his answer, filed May 2, 1985, respondent claimed an increased deficiency of $90 in excise tax pursuant to secs. 4973 and 6214.

In 1981, petitioner was credited with 469 hours of service. Since he terminated his employment in March, petitioner forfeited the $693.53 which the company had voluntarily contributed to his account, and a 1-year break in service occurred. When petitioner left the company he had accumulated no years of service under the plan nor any vested rights under the plan. If he were reemployed by the company he would receive no credit for his previous participation in the plan.

Petitioner made contributions during the year of $1,500 to an IRA. Petitioner deducted this amount on his 1981 Federal income tax return. Respondent disallowed petitioner's deduction under section 219(a) for the IRA contribution because he determined that petitioner was an active participant in a qualified retirement plan. Petitioner argues that since he has forfeited all rights under the plan, no potential for a double tax benefit exists. Petitioner relies on *Foulkes v. Commissioner*, 638 F.2d 1105 (7th Cir. 1981), revg. T.C. Memo. 1978–498.

OPINION

Section 219, as applicable for 1981, allows for the taxable year, a deduction of up to $1,500 for a contribution to an IRA described in section 408(a). Nevertheless, section 219(b)(2)(A)(i) provides that no deduction for a contribution to an IRA will be allowable for a taxable year for any individual who was an active participant in a qualified pension plan for any part of such year.[4] A person can be considered an active participant even though he had only forfeitable rights to plan benefits and those rights were, in fact, forfeited prior to becoming vested. *Hildebrand v. Commissioner*, 683 F.2d 57, 58 (3d Cir. 1982), affg. T.C. Memo. 1980–532; *Horvath v. Commissioner*, 78 T.C. 86 (1982); *Orzechowski v. Commissioner*, 69 T.C. 750 (1978), affd. 592 F.2d 677 (2d Cir. 1979).

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[4] Sec. 219 has been amended to allow persons covered by qualified plans to take deductions for contributions to IRA's in taxable years beginning after Dec. 31, 1981. See sec. 311(a), Economic Recovery Act of 1981, Pub. L. 97–34, 95 Stat. 172, 274. This change was not made retroactive.

This case is indistinguishable from *Hildebrand v. Commissioner, supra*, and we reach the same conclusion here. Despite the fact that petitioner worked for the company for only 3 months during 1981 and forfeited his rights under the plan, he is not entitled to a deduction for an IRA contribution because he was an active participant in his company's retirement plan. While Congress did not include a definition of active participant in the statute, Congress' intent is clear from the report of the House Committee on Ways and Means:

> An individual is to be considered an active participant in a plan if he is accruing benefits under the plan even if he has only forfeitable rights to those benefits. [H. Rept. 93–807 (1974), 1974–3 C.B. (Supp.) 236, 364.]

While the result to petitioner seems harsh, we cannot ignore the plain language of the statute and, in effect, rewrite this statute to achieve what would appear to be an equitable result. See *Hildebrand v. Commissioner*, 683 F.2d at 59. We have considered the case of *Foulkes v. Commissioner, supra*. However, since we find this case to be indistinguishable from *Hildebrand v. Commissioner, supra*, we follow our decision, as affirmed by the Third Circuit, in that case.[5] Whether or not petitioner could potentially receive a double tax benefit is not the critical inquiry. Instead, the significant fact is that petitioner was an active participant in the company's plan during the first 3 months of 1981. *Chapman v. Commissioner*, 77 T.C. 477, 480 (1981); *Johnson v. Commissioner*, 74 T.C. 1057, 1060 (1980), affd. 661 F.2d 53 (5th Cir. 1981).[6]

Finally, section 4973 imposes an excise tax of 6 percent on "excess contributions" made to an IRA during the taxable year. Section 4973(b) defines "excess contributions," for the purpose of the instant case, as the excess of the amount contributed to the IRA for the taxable year over the amount allowable as a deduction under section 219.

Since petitioner is not entitled to a deduction under section 219 for his contribution for $1,500 to an IRA in 1981, the entire $1,500 represents an excess contribution subject to the excise tax. *Orzechowski v. Commissioner*, 69 T.C. at 755–756. This result follows despite petitioner's misunderstanding of the requirements of section 219. "Willfulness is not an element in the imposition of the excise tax under section 4973." *Johnson v. Commissioner*, 74 T.C. at 1061.[7] The section 4973 tax is imposed to offset the benefit that would otherwise flow from exempting from current taxation the earnings on contributions that exceed the maximum permitted contributions. *Benbow v. Commissioner*, 82 T.C. 941, 950–951 (1984), on appeal (6th Cir. and 7th Cir., Nov. 26, 1984); *Boggs v. Commissioner*, 83 T.C. 132, 152–153 (1984), on appeal (4th Cir. and 6th Cir., Jan. 10, 1985).

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[5] We have found no cases decided on this issue by the Court of Appeals for the Ninth Circuit; this case would be appealable to the Ninth Circuit. *Golsen v. Commissioner*, 54 T.C. 742, 751 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971).

[6] We have followed this approach in many cases. E.g., *Van Sant v. Commissioner*, T.C. Memo. 1984–535; *Craine v. Commissioner*, T.C. Memo. 1984–513; *Pizor v. Commissioner*, T.C. Memo. 1979–487; *Kacin v. Commissioner*, T.C. Memo. 1979–410; *Cooper v. Commissioner*, T.C. Memo. 1979–256.

Accordingly, respondent's determination is sustained.

Decision will be entered for the respondent.

CIBA-GEIGY CORPORATION, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2831–78. Filed August 1, 1985.

G, a Swiss corporation, granted to P, its wholly-owned U.S. subsidiary, an exclusive license to manufacture, formulate, and sell certain triazine herbicides in the United States. In return, P agreed to pay G a royalty equal to 10 percent of net sales. *Held*, R abused his discretion under sec. 482, I.R.C. 1954, when he determined that a 10-percent royalty rate did not constitute an arm's-length consideration for the license agreements in issue, subject, however, to a reasonable allocation for certain services performed by petitioner. Sec. 1.482–2(d), Income Tax Regs., applied.

Wayne E. Chapman, *Richard L. Hoffman*, *Douglas R. Cox*, *Stephen D. Poss*, *Robert L. Nowicki*, and *Henry B. Gutman*, for the petitioner.

Stanley J. Goldberg, *David M. Brandes*, and *Richard M. Duncan*, for the respondent.

NIMS, *Judge*: Respondent determined deficiencies in petitioner's income taxes and liabilities for withholding of income

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[7] See also *Day v. Commissioner*, T.C. Memo. 1985–251.

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taxes at the source in the amounts and for the taxable years, as follows:

TYE	*Income tax deficiencies*
Dec. 31, 1965	$4,497,101.75
Dec. 30, 1966	5,869,605.06
Dec. 29, 1967	9,027,112.01
Jan. 3, 1969	12,211,807.46
Dec. 26, 1969	23,487,352.55
Total	55,092,978.83

TYE	*Liabilities for withholding income taxes at source*
Dec. 31, 1965	$468,448.09
Dec. 31, 1966	611,417.19
Dec. 31, 1967	940,324.16
Dec. 31, 1968	1,156,421.15
Dec. 31, 1969	1,415,440.02
Total	4,592,050.61

The foregoing deficiencies and liabilities reflect amounts determined in a deficiency notice, a statutory notice of liability, and an amended answer, as follows: In respondent's statutory notice of deficiency, dated December 23, 1977, deficiencies were determined in petitioner's income taxes for the taxable years and in the amounts, as follows:

TYE	*Income tax deficiencies*
Dec. 31, 1965	$3,345,184.80
Dec. 30, 1966	4,147,053.36
Dec. 29, 1967	6,331,047.37
Jan. 3, 1969	8,071,319.51
Dec. 26, 1969	17,844,438.00

Respondent also issued a statutory notice of liability for withholding of income taxes at the source on December 23, 1977, as follows:

TYE	*Liabilities for withholding income taxes at source*
Dec. 31, 1965	$348,457
Dec. 31, 1966	432,032

TYE	*Liabilities for withholding income taxes at source*
Dec. 31, 1967	$659,484
Dec. 31, 1968	764,330
Dec. 31, 1969	881,073

Respondent's statutory notice of deficiency disallowed a portion of the agricultural chemical royalties paid by petitioner to its parent company. Respondent reduced petitioner's claimed 10-percent royalty rate to a 6-percent royalty rate, which 4-percent reduction resulted in the disallowance of the following amounts of royalties:

TYE	*Amounts of royalties disallowed*
Dec. 31, 1965	$1,654,712.54
Dec. 30, 1966	2,433,541.00
Dec. 29, 1967	3,804,337.08
Jan. 3, 1969	5,343,224.60
Dec. 26, 1969	7,417,190.55
Total	20,653,005.77

In an amended answer, respondent sought to disallow the previously allowed and remaining royalties paid by petitioner to its parent company. As set forth in the amended answer on November 30, 1982, the proposed additional disallowances were as follows:

TYE	*Additional amounts of royalties disallowed*
Dec. 31, 1965	$2,399,826.98
Dec. 30, 1966	3,587,711.89
Dec. 29, 1967	5,616,801.34
Jan. 3, 1969	7,841,833.13
Dec. 26, 1969	10,687,337.52
Total	30,133,510.86

Based on these proposed additional disallowances respondent asserted increased deficiencies in petitioner's income taxes as follows:

TYE	*Amounts of deficiencies*
Dec. 31, 1965	$1,151,917.15
Dec. 30, 1966	1,722,101.70

TYE	*Amounts of deficiencies*
Dec. 29, 1967	$2,696,064.64
Jan. 3, 1969	4,140,487.95
Dec. 26, 1969	5,642,914.55

Petitioner asserted in its petition a setoff claim against respondent's proposed section 482 allocation. Petitioner asserts this claim on the ground that an unrelated third party dealing at arm's length with petitioner's Swiss parent corporation would have been willing to pay a 15-percent royalty rate for the triazine licensing rights involved in this case. Based on this proposition, petitioner alleges entitlement to an increased annual deduction for additional royalties payable to its parent. Petitioner calculated the amounts of these deductions as follows:

TYE	*Amounts asserted to be deductible*
Dec. 31, 1965	$2,068,390
Dec. 30, 1966	3,041,925
Dec. 29, 1967	4,755,451
Jan. 3, 1969	6,679,061
Dec. 26, 1969	9,271,487
Total	25,816,314

After concessions, the issues for decision are:

(1) Whether royalty payments made by petitioner to its Swiss parent corporation in exchange for licensing rights to make, use, and sell triazine herbicides in the United States were excessive under the arm's-length standard of section 482[1] and therefore subject to reallocation; and

(2) Whether royalty payments disallowed by respondent constitute dividends subject to the section 1442(a) 5-percent withholding of income tax at the source.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulations and their attached exhibits are incorporated herein by this reference.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 in effect for the years in question. All Rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner Ciba-Geigy Corp. (Ardsley or petitioner), a New York corporation, had its principal place of business in Ardsley, New York, at the time of filing its petition in this case. Petitioner is an accrual basis taxpayer. For all taxable years in issue, petitioner utilized a 52- 53-week year as its taxable year except for the year 1965 when it used a calendar year.

1. Organizational Histories of Petitioner and Swiss Parent Company

The Swiss parent company of Ardsley was founded in Basle, Switzerland, in 1758 as a family-operated trading company specializing in imported dyestuffs. By the mid-1860s, the company commenced production of synthetic aniline dyes. In 1862, it built a factory in Basle to assure volume production capability of the synthetic aniline dyes. Beginning in the late 1860s, the parent company established an experimental chemical laboratory at its Basle facility; it has maintained this laboratory to the present time. Prior to 1870, the parent company had built a network of central and western European sales agents and representatives to distribute its products; in the 1870s, it expanded this network to include various European countries, India, the Far East, and the United States.

On January 1, 1901, the original parent company was reorganized from a family operation into a joint stock company, and in 1914 it adopted the name of J. R. Geigy S.A. In 1903, the original Swiss parent company organized the Geigy Aniline and Extract Co. (GAE) as a wholly owned subsidiary to market and sell its products in the United States. In 1909, Geigy-ter-Meer Co., later Geigy Co., Inc., was organized in New York to succeed GAE. In 1952, the assets of Geigy Co., Inc., were acquired by petitioner, a newly formed corporation incorporated under the name Geigy Chemical Corp. as a wholly owned subsidiary of J.R. Geigy, S.A. In 1956, petitioner's principal place of business was moved from New York City to Ardsley, New York.

In October 1970, J. R. Geigy, S.A., merged with another Swiss chemical and pharmaceutical company, Ciba, Ltd., to form Ciba-Geigy, Ltd. (Geigy-Basle). At the same time, Ciba Corp., a wholly owned subsidiary of Ciba, S. A., merged into petitioner. At that time, petitioner's name was changed to Ciba-Geigy Corp.

Petitioner was exclusively a dyestuffs and dyestuffs auxiliary marketing company until 1943; it did not have manufacturing or research capability. Petitioner mixed the dyestuffs and auxiliary products purchased from Geigy-Basle and from another company, Cincinnati Chemical Works. Petitioner shipped the finished mixed product from its central shipping facility in Bayonne, New Jersey, to its U.S. customers.

By 1943, Geigy-Basle has created the insecticide chemical DDT and had applied for a patent in the United States. Because the U.S. Government viewed DDT as "potentially significant" to its military operations during World War II, it placed DDT and its related chemical compounds under U.S. governmental control and secrecy requirements. During the War, the U.S. Government required Geigy-Basle to grant licenses under its pending U.S. DDT patent application to a number of U.S. companies for the manufacture and sale of DDT to the Government. In 1943, Geigy-Basle transferred its rights under the pending U.S. DDT patent application to petitioner. Petitioner established a manufacturing and sales licensing program to supply DDT to the U.S. Government; under this program, petitioner licensed such companies as Du Pont, General Chemical, and Hercules. On August 31, 1945, the U.S. Government released DDT from military control. Petitioner began expansion of its DDT-licensing program and ultimately licensed over 800 firms to manufacture and sell DDT. However, petitioner also marketed its own DDT formulations and thus remained in direct competition with its licensees.

Ardsley found it difficult to compete with its licensees which were large chemical manufacturers and producers. Many licensees offered "full lines" of agricultural chemical products including insecticides, fungicides, and inorganic herbicides. As a result of the stiff competition, petitioner embarked on a program to expand its stance in the agricultural chemical field. It decided to obtain nonexclusive licenses that cumulatively would enable it to offer a full line of agricultural chemical (agchem) products. Petitioner purchased the active ingredients for such agchem products from third parties in the United States, formulated them into finished products under Geigy-Basle labels, and sold them to independent dealers and distributors. Under its expanded program, petitioner offered approximately 30 to 40 active ingredients formulated into approximately 120 products.

In 1949, petitioner expanded its sales operations to include the sale of Geigy-Basle's pharmaceutical products; petitioner did not engage in manufacturing or research in the pharmaceutical field. In the 1950s, petitioner expanded into the manufacture of industrial chemicals.

As a result of petitioner's expansion program, it realized rapid increases in annual sales from a low of $1.8 million in 1947 to a high of $11.8 million in 1951. Petitioner's annual sales declined after the end of the Korean War. Petitioner was not ranked among the top 10 U.S. producers or marketers of agricultural chemicals prior to 1958. Although petitioner realized periods of expansion and decline of annual sales from 1947 through 1958, its Agricultural Chemicals Division consistently lost money from 1944 through 1958, with the exception of 1951 when the division reported a modest profit. The poor financial performance of the agricultural chemicals division concerned petitioner's management. Dr. George Ferguson was appointed president of petitioner's insecticide division (later known as the agricultural chemicals division) in 1953. Dr. Ferguson attempted to change the financial picture of the insecticide division and decided to retrench. He abandoned petitioner's marketing of its full line of nonproprietary agricultural chemical products, sold its agricultural chemical formulating plants, and eliminated some personnel and branch offices.

2. *Chemical Research Capabilities of Geigy-Basle and Petitioner by 1950*

Between World War I and World War II, Geigy-Basle expanded its staff of chemists and developed its chemical research in the areas of synthetic tanning agents, industrial chemicals, pharmaceuticals, and pesticides. This chemical research expansion resulted in the invention and commercialization of numerous chemicals, including DDT. Discovery of DDT and its widespread use during World War II propelled Geigy-Basle into the field of synthetic pesticides. As a result of intensive research in this field in the 1940's and 1950's, Geigy-Basle developed and commercialized such synthetic chemical pesticides as: (a) kik, an insect repellant; (b) gesin, an herbicide; (c) dimetan, pyrolan, pyramate, isolan, and diazinon, various insecticides; (d) etoxilon and chlorobenzilate, two acaricides; (e) tomorin, a rodenticide; and (f) mesulfan, a fungicide. By 1951, Geigy-Basle had established a long and excellent track record on research and development of insecticides, miticides, fungicides, and rodenticides.

By 1953, Geigy-Basle had approximately 45 foreign subsidiaries and had built a sizable network of third-party licensees to handle marketing and sales of pest control and other chemicals. Since 90 percent of Geigy-Basle's output was exported for sale outside Switzerland, these subsidiaries and licensees were important to Geigy-Basle's worldwide sales. Although a major role of Geigy-Basle's subsidiaries and licensees was the sale of Geigy-Basle's products, some of these subsidiaries and licensees also either manufactured Geigy-Basle's product or acquired active ingredients from Geigy-Basle and formulated them into finished products for distribution, or both.

Geigy-Basle's research facilities in or near Basle had grown to include a microanalytical laboratory for verification of chemical compounds and for analysis of formulation, a kilo laboratory for production of experimental compounds in large quantities, a facility for the study of chronic and subchronic toxicity of experimental chemical compounds, facilities for analyzing chemical residues in soils and plants, a pilot plant to develop commercially practical methods for producing experimental compounds in commercial quantities, an application department to develop effective chemical formulations and to explore combinations of experimental compounds, a chemical research library, a scientific literature service, and a patent department to administer corporate patents and patent applications. Geigy-Basle also maintained greenhouses and an experimental garden and field for small plot field testing. Large-scale field testing was accomplished on several farm sites nearby, including Schweizerhalle and Pfeffingen.

By 1950, Geigy-Basle's research staff included approximately 50 chemists (specialists in synthetics with Ph. D. degrees) and their support staffs. These chemists developed, experimented with, and tested numerous pesticides. It was not unusual for these chemists to call upon other chemists at the University of Basle to assist with Geigy-Basle's research needs.

Among the most important Geigy-Basle chemists and biologists were Dr. Albert Gast, Dr. Enrico Knuesli, and Dr. Hans Gysin.

Dr. Albert Gast[2] joined Geigy-Basle on February 1, 1943, as a biologist. Among his early assignments were the biological testing of DDT products and the testing of experimental insecticides and fungicides for phytotoxic activity on plants. From 1946 to 1948, he screened chemical compounds at Basle, hoping to identify some herbicides related to, but having advantages over, 2,4-D, an herbicide used on corn and other crops. This screening program resulted in a chemical product known as gesin. Thereafter, Dr. Gast continued testing insecticides and fungicides for their phytotoxic activities on plants. In 1951, Dr. Gast worked on Geigy-Basle's herbicide-defoliant project at Schweizerhalle; he designed a primary screening program[3] to biologically test the compounds synthesized for that project.

Dr. Enrico Knuesli[4] was hired in the autumn of 1951 to work as a synthesis chemist for Geigy-Basle; he commenced work in March 1952. Dr. Knuesli was assigned to a synthesis group headed by Dr. Gysin which worked in the pesticide field. Dr. Knuesli was involved in the herbicide-defoliant project during the mid-1950's.

Dr. Hans Gysin[5] commenced work for J. R. Geigy, S.A., on

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[2] Dr. Albert Gast received his Ph.D. degree in botany with a major in plant physiology from the University of Basle in 1941. His doctoral dissertation was a study of the influence of plant growth substances on the root growth of corn. Dr. Gast has been a member of the Swiss Botanical Society since 1941.

[3] Primary screening is a relatively routine testing process. It is usually performed in a greenhouse by a technician who is supervised by a biologist. The general purpose of primary screening is to determine which chemical compounds are biologically and herbicidally active, and thus deserving of additional testing. Primary screening can take the form of pre-emergence or post-emergence testing at selected dosages. In pre-emergent primary screening, generally a flat is sown with seeds, and a chemical solution either is mixed or is drenched into the soil. In post-emergent primary screening, the chemical solution is sprayed onto the growing weeds after they have reached a certain growth height. Observations are made of the drenching and spraying effects.

[4] Dr. Enrico Knuesli received his Ph.D. degree in chemistry from the Federal Institute of Technology in Zurich, Switzerland, in 1948. Dr. Knuesli completed 4 years of postdoctorate study at the Instituto Superiore Di Sanita, the Italian Institute of Health, in the fields of curariactive compounds and cardiotonics. During Dr. Knuesli's postdoctoral work, he submitted his synthesized pharmaceutical compounds to pharmacologists and M.D.'s on the research team who tested the compounds on animals.

[5] Dr. Hans Gysin received his Ph.D. degree from the University of Basle in 1938. His major was in organic chemistry and his minors were in inorganic chemistry, physical chemistry, and mineralogy. Dr. Gysin was promoted regularly during the 1940's, 1950's, and 1960's. Following a corporate reorganization of Geigy-Basle in 1968, Dr. Gysin became an assistant head of the agricultural chemical chemistry research division (Agchem). His responsibilities included re-

July 1, 1938, as research chemist in the pharmaceutical research department. Dr. Gysin was promoted to research group leader in approximately 1945, and his research group became involved in insecticide research in 1948. His research group expanded into fungicides in 1949 and into herbicides in 1951. Dr. Gysin became the head of Geigy-Basle's agricultural chemical chemistry research department (Agchem) in 1955. He was promoted to the head of Geigy-Basle's entire Agchem research department in 1957 and was a member of Basle's technical committee which reported directly to top management.

Petitioner opened its Bayonne, New Jersey, laboratory on the grounds of the Bayonne dyestuff mixing and central shipping facilities in 1946. The original purpose of the laboratory was to provide to petitioner's insecticide department technical service[6] and formulation support with regard to the chemical compound DDT. Between 1946 and 1951, the laboratory's activities expanded to provide technical service and fomulation work for numerous chemical compounds for the pharmaceutical department. It was not until the mid-1950's that personnel at the Bayonne laboratory engaged in basic research, chemical synthesis, primary screening, or microanalytical work.

In the early 1950's, petitioner developed as two major capabilities the formulation of various agricultural chemicals[7] and pharmaceutical sales. Additionally, it operated a farm in Elkton, Maryland, for the purpose of field testing pesticides.

Petitioner employed a number of chemists, biologists, and scientific assistants in the 1950's, including Dr. George Ferguson, Dr. Joe Antognini, Herb Day, and Jim Flanagan. Dr. Ferguson[8] commenced work at the Bayonne, New Jersey,

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search, development, marketing, and logistics. In 1969, Dr. Gysin became the executive head of Geigy-Basle's Agchem division.

[6] Technical service involves handling customers' complaints, requests, and correspondence; providing technical data and sales literature; and conducting field tests of formulations of commercialized products.

[7] Petitioner had 10 formulating plants located in Lockridge, Iowa; Houlton, Maine; Elkton, Maryland; McGregor, Texas; Aberdeen, North Carolina; Orlando, Florida; Lelan, Mississippi; Fresno, California; Walla Walla, Washington; and Colorado Springs, Colorado. Pursuant to Dr. Ferguson's retrenchment program, in late 1955, petitioner sold its 10 formulating plants.

[8] Dr. Ferguson received his Master of Science degree in entomology in 1939 from Oregon State University and his Ph.D. degree in entomology from Ohio State University in 1941. From 1943 through 1945, Dr. Ferguson was a research fellow at the Crop Protection Institute in New Hampshire.

facility in April 1945, as chief entomologist. Among Dr. Ferguson's early responsibilities was the commercial development of DDT for agricultural and other uses. From approximately 1947 to 1953, Dr. Ferguson was technical director of petitioner's insecticide department; his duties consisted of supervising the formulation of DDT products, third-party products, and the Bayonne laboratory. From 1953 to 1969, Dr. Ferguson was president of petitioner's Agchem division. Dr. Antognini[9] was hired by petitioner in 1951 as a synthesis chemist. Dr. Antognini reported directly to Dr. Ferguson or Dr. Ferguson's assistant, Mr. C.C. Alexander. Dr. Antognini worked on the herbicide-defoliant project and initiated its primary screening program for petitioner. Dr. Antognini left petitioner's employ in fall, 1954. Herb Day and Jim Flanagan were hired by petitioner to assist in the herbicide-defoliant project screening process from 1952 through 1955.

3. *Herbicide-Defoliant Project*

On the invitation of Mr. Dieter Burckhardt, head of Geigy-Basle's Pesticide Sales Department, Dr. Ferguson visited Geigy-Basle in September 1950. One purpose of this visit was to discuss the chemical "mitin." While in Switzerland, Dr. Ferguson toured Geigy-Basle's facilities, including its chemical laboratories at Schweizerhalle. Dr. Ferguson was asked to give an impromptu speech; he spoke on U.S. agricultural trends and on the U.S. market for agricultural chemicals.[10] Dr. Ferguson generally described the state of the insecticide and acaricide fields in the United States and trends towards monocultures and mechanization. During his Swiss visit, Dr. Ferguson invited Dr. Gysin to visit the United States to observe the U.S. agricultural chemicals market and to consider its potential. Dr. Gysin was receptive and both men decided to pursue the proposed visit with their respective managements.

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[9] Dr. Antognini received his degree in plant sciences from the University of California at Davis, California, in 1948. He received a Ph.D. degree in horticulture from Cornell University in 1951. His major study at the universities was in vegetable crops. After leaving the employment of petitioner in fall, 1954, Dr. Antognini worked for Stauffer Chemical Co.

[10] As a result of increased mechanization and fertilizers used in the United States, the U.S. agricultural production of corn and other crops had increased since World War II. Many people viewed the 1950's as the time to develop herbicides to treat the increasing crop acreage.

Following his Swiss trip, Dr. Ferguson wrote a letter, dated January 4, 1951, to Charles Koechlin, president and chairman of the Geigy board of trustees and chairman of the Ardsley board of trustees. Dr. Ferguson commented in his letter on the "possibility of setting up a basic research project on the development of new defoliants and herbicides in the U.S." The letter explained that existing herbicides were unsatisfactory for use on U.S. crops of cotton, soybeans, alfalfa, and corn. Dr. Ferguson stated his belief that there was great opportunity for profitable research in the defoliant and herbicide fields. Dr. Ferguson stated that—

> The primary objective of research work in this field is, of course, the discovery and development of patentable new compounds and products that may be commercially useful * * *. Since defoliation is biologically an herbicidal action, no distinction should be made in the basic research program between the two. The distinction will come about naturally during the development and test program of any compounds that show activity of interest.
>
> The procedure to be followed would consist of three steps:
>
> 1-Chemical synthesis of the compounds.
>
> 2-Screening tests on several types of plants to determine biological activity.
>
> 3-Survey tests in the field to determine range of usefulness.
>
> Compounds showing promising results would then be subjected to full scale field evaluation in cooperation with federal and state experiment stations.

Dr. Ferguson proposed that the research team should be composed of a chemist, an agronomist, and a greenhouse assistant. He indicated that the physical plant at the Bayonne Laboratory would be adequate to undertake the project. He estimated an annual budget of $30,000 to employ personnel and to cover supplies, overhead, travel, and contingencies. Dr. Ferguson recommended that such a program—

> should be set up on no less than a 5 year basis * * *. [i]n order to tie the program in closely with Basle's basic research program, it is suggested that one of your experienced chemists might take over the chemical side of the project. Close liaison could then be easily maintained as well as bringing all applicable research methods to bear on the problem as such methods have been developed in Basle.

On February 14, 1951, Dr. Gysin wrote a memorandum in which he recommended a 5-year program to find and produce superior and cheaper chemical compounds for use as weed killers and defoliants. Dr. Gysin stated that from 1946 through 1948 numerous compounds were investigated for use as weed killers; none showed satisfactory results in the field. Therefore, Dr. Gysin stated:

> Since our weeds in Switzerland are very different from those in the U.S.A., and since this is provisionally a problem whose solution chiefly interests the United States, only New York comes under consideration for testing. In order to lose no time, Geigy-New York would have to be capable of testing substances as early as the spring. The delivery of these substances as models could take place from Basle in the next few months. A definitive taking up of chemical research in the U.S.A. should be out of the question because of insufficient laboratory facilities and also because of a lack of suitable chemists and auxiliary personnel. If for external reasons a shift of part of the chemical research to the U.S.A. should become necessary, then laboratory buildings would be a prerequisite. Until the realization of such a project, more could be accomplished from Basle, in my opinion (if necessary, two to three chemists could be used for this work), and if nothing positive were to come out of this line of work in a few years, then our chemists could be otherwise employed and the biologists in the U.S.A. could work for sales or be discharged. * * *

At the end of the memorandum, Dr. Gysin set forth immediate measures to be taken by Giegy-Basle and by Ardsley, as follows:

> ### 4. *Immediate Measures.*
>
> *For Basle:*
>
> (a) Production of a literature and patent inventory concerning the herbicide area, including the true growth substances, the mono-and dicotyledon herbicides and defoliants (will be completed by February 15, 1951 by Dr. Oeschger and Mr. Spindler).
>
> (b) Selection of substances. There is available a list of about 40 substances which are ready for shipment by February 15.
>
> (c) Production of a number of compounds, which are proposed for this area according to the latest state of technology, as well as synthesis of some substances which should lead us away from what is known.
>
> (d) Designation of an office for coordination, to which maintenance of contact between the chemistry department in Basle and development work in New York will be assigned.
>
> *For New York:*
>
> (a) Employment of a suitable biologist and an appropriate assistant for the coming spring.
>
> (b) Carrying out of the known laboratory test for herbicides.
>
> (c) Development of a laboratory test for defoliants.
>
> (d) Initiation of field tests for several monocultures, especially cotton and potatoes, for weed control.

(e) Initiation of field tests with substances that have shown themselves to be possible defoliants in the laboratory.

For Basle and the U.S.A.:

Thorough discussion of problems between Dr. Ferguson and the further testing stations (possible national institutes) and a representative of the chemical department in Basle (already planned for) in the course of this year.

Make proposal for further work at the end of these personal contacts or after conclusion of the first season of testing.

In the late 1950's or early 1951, Dr. Gysin commissioned Geigy-Basle's staff to study publications to determine existing organic and inorganic herbicide compounds and research methods before embarking on research for the herbicide-defoliant project. Mr. Max Spindler completed this study in March 1951. The study found that the leading chemical herbicide group produced in 1950 was the 2,4-D-type herbicides which were effective against broadleaf weeds. The study also showed that IPC-type herbicides were available and effective against grassy weeds. The study further determined that Geigy-Basle had the necessary facilities and capabilities to undertake a herbicide research project. Geigy-Basle's available capability and facilities included general research know-how; experience in, and facilities for, synthesis and biological screening for pharmaceuticals and pesticides; auxiliary services such as analytical, toxicology, pharmacology, and kilo laboratories; a pilot plant operation; patent services; and an extensive scientific library.

In March 1951, Dr. Gysin sent to petitioner a selection of chemical compounds for future testing. Dr. Gysin never saw a report from Dr. Antognini on his test results on these compounds.

In the summer of 1951, Dr. Gysin traveled through the United States escorted by Dr. Ferguson and Mr. Alexander. The focus of Dr. Gysin's travel was threefold: (1) To gather information on agricultural chemicals generally, including insecticides, fungicides, acaricides, and herbicides; (2) to monitor DDT's performance; and (3) to become aware of the performance of Geigy-Basle's new acaricides, insecticides, and pharmaceuticals in the United States. Dr. Gysin visited U.S. Department of Agriculture and other agricultural experimental stations, dealers, distributors, corn fields, farms, and farm cooperatives in the midwest, southwest, and western United

States. Dr. Gysin observed defoliant tests on cotton, the irrigation and nonirrigation of cotton, growth of apple orchards, work performed using DDT-impregnated wood as a means of preventing termite infestation, etc.

Toward the end of Dr. Gysin's visit in the United States, petitioner's board of trustees met on October 2, 1951. The persons present from Ardsley included Dr. Ferguson, Mr. Alexander, and Mr. Suter, Ardsley's executive vice president. From Geigy-Basle, Dr. Gysin, Dr. H. Koechlin, vice president in charge of research and production, and Dr. R. Wiesmann, in charge of Geigy-Basle's biological research department, attended. The minutes of the October 2, 1951, meeting, dated October 22, 1951, showed: (1) Dr. Ferguson's revised belief that the chemical work on the herbicide-defoliant project should be confined to Basle; (2) the suggestion that screening for herbicidal and defoliation effects should be performed first in Basle and that only those compounds showing biological activity should be sent to Bayonne for testing; (3) recognition that Geigy-Basle and Ardsley would utilize different test methods, different test plants, and different views in evaluating the compounds; (4) agreement that compounds in each chemical group studied in Geigy-Basle would be sent to Bayonne for testing, regardless of the biological activity shown by Geigy-Basle's tests; (5) agreement that Ardsley's and Geigy-Basle's first work would be the development of rapid screening test methods for the evaluation of chemical compounds; (6) agreement that the chemical compounds which showed sufficient laboratory and greenhouse activity would be sent to Ardsley for field testing; (7) recognition that after Ardsley obtained patent clearance, it would be responsible for sending the compounds to the appropriate Federal and State experimental stations; (8) agreement that close contact between Geigy-Basle and Ardsley was essential; this resulted in a recommendation for frequent trips by the project's researchers; (9) discussion of the advantages of a small, active, research nucleus in the United States consisting of at least a senior research chemist from Geigy-Basle; (10) deferral of resolution of the issue concerning whether basic agricultural chemical research should be undertaken in the United States; and (11) the stated aim of the herbicide-defoliant project to be the search for all chemical compounds with plant growth influencing activity.

Dr. H. Koechlin placed Dr. Gysin in charge of the herbicide-defoliant project. Dr. Knuesli was selected to perform the project's synthesis work for Geigy-Basle.

As an initial step in the herbicide-defoliant project, Dr. Gysin formulated a plan to synthesize various chemical compounds.[11] The purposes of Dr. Gysin's plan were to limit the number of chemical compounds to be tested and to define the herbicidal effect for which he was searching. Dr. Gysin selected approximately 25 different chemical groups to investigate as potential herbicides. He gave preference to 7 of the 25 groups, including the: carbamates, chlorophenyl acetic acid-type compounds, chlorophenol derivatives, chloroanilino-type compounds, cinnamic acid derivatives, cyanuric chloride derivatives, and ureas. These groups were selected because they were structurally related to such existing herbicides as 2,4-D, IPC, and CMU. Dr. Gysin included cyanuric chloride derivatives based on his knowledge from the pharmaceutical and the dyestuffs fields. He hoped that the urea bridge of a herbicide of the CMU-type compound might be substituted to obtain an herbicidally active triazine. Dr. Gysin hoped to find that, unlike 2,4-D and other existing herbicides, urea-derived herbicides might control both grassy and broadleaf weeds.

Dr. Gysin's chemical synthesis plan served as a framework for Dr. Knuesli to perform the actual chemical synthesis work. Dr. Knuesli reviewed Dr. Gysin's plan and concluded that the plan included a bias or assumption toward synthesizing compounds that included an aryl substituent. After Drs. Knuesli and Gysin discussed the chemical groups included in Dr. Gysin's plan, Dr. Knuesli decided that the synthesis plan needed expansion to include chlorazine compounds.

Before Dr. Knuesli embarked on the synthesis of a particular compound, he determined whether the prospective compound previously had been described in scientific literature.[12] If the prospective compound had not been described previously, he considered synthesizing it; if the compound had been described, he might synthesize it anyway.

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[11] Dr. Knuesli explained at trial that chemical synthesis "means to react two chemical entities in order to get out from the reaction of these two, a new chemical." The new chemical may be reacted with others to produce new desired chemical compounds. Prior to the actual synthesis process, the chemist determines the use for which he is seeking to synthesize the chemical compounds.

[12] A chemical compound described in the literature would generally give its physical characteristics and indicate how it was synthesized. The compound might be described in the literature even though it did not have known herbicidal properties.

After Dr. Knuesli synthesized particular compounds, he also evaluated their approximate solubilities. This solubility information was intended to benefit the biologist who later would screen the compounds for biological activity. Dr. Knuesli maintained the synthesis process and the solubility information regarding the synthesized compounds in his laboratory notebook.

After Dr. Knuesli synthesized a chemical compound, he routinely sent a sample to Geigy-Basle's microanalytical group for verification that the molecular content of the synthesized compound matched the molecular content of the compound that he had intended to synthesize.[13] Dr. Knuesli then assigned a code number to the synthesized compound and divided the compound sample into two parts; one portion to be sent to Dr. Antognini at Bayonne and one to be given to Dr. Gast at Geigy-Basle for biological screening. The amount of the chemical sent to Dr. Antognini and to Dr. Gast varied from compound to compound.

Dr. Gast designed and supervised Geigy-Basle's primary screening program for the herbicide-defoliant project. The purpose of his primary screening program was to show which compounds produced phytohormonal activity. His screening plan included the use of known herbicides as standards against which to test the effects of various compounds for suitability as herbicides on a variety of greenhouse test plants. Dr. Gast used solvents or emulsifiers to apply the synthesized compounds to the test plants. Dr. Gast performed his work on the project at Schweizerhalle's facilities, which included a lab, two greenhouses, and two experimental gardens.[14]

Dr. Gast performed four primary tests including a soil germination test, a watering test, a burning test, and a phytohormone test. Dr. Gast investigated the potential epinastic[15] and phytohormonal[16] activities. Dr. Gast's primary screening test methods were conducted as follows:

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[13] This verification process was performed prior to primary screening.

[14] At the commencement of the project, Dr. Gast was the only Ph.D. who performed biological screening for the project. He had one trained laboratory aide, one to two laboratory helpers, and a gardening group of three gardeners plus one to two apprentices. Dr. Gast could call upon personnel at the Schweizerhalle facility. In 1955, Dr. Grob, a Ph.D. biologist and his assistants tested compounds for the project in the Rhone Valley.

Test	*Factor*	*Basle*
Soil germination[17]	Application method	Soil incorporation
	Plant species	Cucumbers Mustard Oats Onions
	Replications	1
	Rating system	Percent germination
		Height of plants
Watering test	Application method	Watered emulsion
	Plant species	Oats or wheat Mustard Tomatoes
	Replications	1
	Application rate	1.0 + 0.2 g/m²
	Rating system	No indication
Burning test	Application method	Emulsion sprayed on plants when they have 2 to 4 leaves
	Plant species	Oats Mustard
	Replications	1
	Concentration	1%
	Rating system	0–+++ (0 = no burns) +++ = 100% of plants burned

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[15] Epinastic activity is a twisting or misshaping of the plant caused by a chemical agent.

[16] Phytohormonal activity "reflects a special picture of activities. For example, plants treated with phytohormones * * * start curling." Phytohormonal activity also may affect the size of roots and their growth.

[17] Dr. Gast observed the plants and rated the effects of the herbicides after 10 and 20 days. Two weeks later he observed the plants to determine if the compounds showed any delayed effects.

Test	*Factor*	*Basle*
Phytohormone test	Application method	Apply 2 to 3 drops of olive oil solution on stem of plants
	Plant species	Beans
	Replications	1 (3 to 4 plants)
	Rating system	0–+++ (0 = no reaction)

Dr. Gast often communicated his primary screening test results to Dr. Knuesli. Dr. Gast prepared written reports on each compound; these reports were translated and sent to Dr. Antognini.

If Dr. Gast determined that a compound merited further testing because the primary screening test showed biological activity, he performed secondary screening tests.[18] The purpose of Dr. Gast's secondary screening tests was to obtain information about specific plants' tolerances to selected chemical compounds at certain dosage rates. Thus, Dr. Gast used the same chemical compounds in his primary and secondary screening tests, but in the latter tests, he applied differing dosages of the compounds to the test plants. Dr. Gast's secondary screening tests can be summarized as follows:

Factors	*Basle*
Application method	Water emulsion
Crop species	Wheat Mustard Clover Carrots
Weed species	None
Replications	1 at 1 cm. seed depth 1 at 3 cm. seed depth
Application rate	0.5 g/m^2 (4.5 lbs/A)

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[18] The general purpose of secondary screening tests is to uncover more information on a compound's herbicidal properties detected through primary screening tests. Varying dosages of chemical compounds are applied to plants to show crop selectivity (i.e. whether particular plants show a tolerance to a specific chemical compound). These tests usually are performed in a greenhouse; however, on occasion they are performed outdoors on small plots.

Factors	*Basle*
Time of application	Unknown
Number of seeds	Unknown
Containers	Unknown
Application method	Hand sprayer
Notes on:	Destroys Twisting of leaves

Dr. Gast performed the secondary screening tests between April 22, 1952, and February 11, 1953. Dr. Gysin and Dr. Knuesli observed Dr. Gast's secondary test results at the greenhouse. On completion of the secondary screening procedures, Dr. Gast wrote a report, dated March 10, 1953. Dr. Gast sent Dr. Knuesli his report in order that Dr. Knuesli might synthesize new compounds related to those compounds on which the test results were final.

Dr. Gast performed tertiary tests on selected compounds to obtain information on those compounds' effective dosage rates, soil persistence, and selectivity under field conditions. The selected compounds and existing standard herbicides were tested in fields on small plots. These field plots were located on land at Schweizerhalle and at Geigy-Basle's experimental farm, Pfeffingen. By summer, 1954, Dr. Gast tested the compounds on crops including oats, wheat, peas, carrots, clover, spinach, corn, and potatoes.

Dr. Gast infrequently orally reported the results of his field test. He prepared written reports, although on occasion, the writing of these reports was delayed until yearend. All of Dr. Gast's reports were translated and sent to Dr. Antognini. Dr. Gast never visited Dr. Antognini at the Bayonne laboratory.

Dr. Antognini also performed at Bayonne primary and secondary screening tests and field tests on numerous compounds synthesized by Dr. Knuesli. Dr. Antognini first added the compounds to a solvent for use in application to the test plants. Like Dr. Gast, Dr. Antognini always utilized untreated control plants and a standard known herbicide to assure that results would be noticed. Dr. Antognini recorded his test results in a laboratory notebook and either Dr. Ferguson or

Mr. Alexander countersigned them. The original primary screening test data recorded in the laboratory notebook later was transferred to other sheets of paper. The test results were communicated to Geigy-Basle through Dr. Ferguson or Mr. Alexander. Dr. Antognini never visited Geigy-Basle.

Dr. Antognini utilized different methods and test plants in his primary and secondary screening tests than those used by Dr. Gast. Dr. Antognini utilized four primary screening tests prior to January 1952, including a soil germination test, a watering test, a plant-spraying test, and a petri dish germination test. These four tests can be summarized as follows:

Test	*Factor*	*Ardsley*
Soil germination	Application method	Water after seeding
	Plant species	Cucumbers Radish Barnyard grass
	Replications	3
	Rating system	Percent germination 0 to 10; growth of tops with 10 = same as checks
Watering test	Application method	Watered emulsion
	Plant species	Cucumbers Soybeans Barnyard grass
	Replications	3
	Application rate	6.9 g/m^2
	Rating system	0 to 10; growth of tops Also notes on: Chlorosis of leaves Necrosis of leaves Malformation of leaves Death Defoliation Wilting

Test	*Factor*	*Ardsley*
		Proliferation of stems Epinasty of stems and petioles Strength of stems
Plant spraying test	Application method	Emulsion sprayed on 2-week-old plants
	Plant species	Cucumbers Soybeans Barnyard grass
	Replications	3
	Concentration	1%
	Rating system	0 to 10; growth of tops 10 = normal growth Also notes on the same list as Watering test above
Petri dish germination test	Application method	5 ccs of a 0.1% solution in petri dish with 25 or 50 seeds
	Plant species	Cucumbers Radish Barnyard grass
	Replications	3
	Rating system	0 to 10; growth of tops and roots 10 = normal growth Also notes on: Thickness of stems, chlorotic, burned or malformed leaves, secondary roots, root hairs and color of roots.

Dr. Antognini wrote a report, dated March 4, 1952, on the results of his primary screening tests.

During 1952, Dr. Antognini performed primary screening tests on more than 100 Geigy-Basle chemical compounds; he wrote six reports on his results. In 1953, Dr. Antognini performed primary screening tests on 187 Geigy-Basle compounds; he wrote six reports on the results of these tests. Additionally, in 1953, Dr. Antognini performed secondary screening tests of numerous Geigy-Basle compounds. His secondary screening test methods can be summarized as follows:

Factors	*Ardsley*
Application method	Water emulsion Water emulsion after 2 weeks
Crop species	Lima beans Soybeans Corn, sweet Peas Cotton Cucumbers Radish Oats
Weed species	Wild mustard Barnyard grass Red root Crabgrass Others
Replications	3
Application rate	3 lbs/A 30 lbs/A
Time of application	Immediately after seeding Two weeks after plant emergence
Number of seeds	10 crop seeds 50 weed seeds
Containers	13″ × 20″ flats
Application method	Automatic spray table

Factors	*Ardsley*
Information sought	Percent control of weeds Percent kill of crop Effect on growth of crops and weeds - 2 weeks
Notes on:	Chlorosis of leaves Necrosis of leaves Death of leaves Defoliation Wilting of plants Proliferation of stems Epinasty of stems and petioles Strength of stems

Although the screening techniques and field testing techniques of Dr. Gast and Dr. Antognini differed, both men utilized generally available and acceptable testing methods. Both used pre-emergent primary screening techniques which would identify phytotoxicity activity. It was not necessary to have "in-house" biological screening capability. Geigy-Basle could have contracted a private organization, such as Boyce-Thompson or Wisconsin Alumni Research Foundation, to perform screening tests on Geigy-Basle's behalf. Typically, the tests would have been performed under a prearranged fee schedule. The private testing organization generally would not have received any licensing rights.

4. Discovery of the Triazine Herbicides

Between 1952 and 1969, approximately 2,000 triazine compounds were synthesized at Geigy-Basle. Dr. Knuesli commenced his synthesis of the first triazine compound, chlorazine, on September 2, 1952. Prior to its synthesis, chlorazine was a known chemical compound but it did not have a known use; it previously had never been examined for herbicidal properties.[19] After Dr. Knuesli synthesized chlorazine, he assigned it code number G25804. He sent samples of the compound to Dr. Gast and Dr. Antognini for screening.

Dr. Gast performed primary screening tests on chlorazine as follows:

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[19] The structure of chlorazine is a cyanuric derivative without an aryl radical.

Test	*Date commenced*	*Date completed*
Phytohormone	11/26/52	12/5/52
Germination	11/24/52	12/23/52
Contact (spray)	12/15/52	12/30/52
Defoliant	3/18/53	4/2/53

In these tests, Dr. Gast utilized plant flats; observations were made for 1 month. Dr. Gast observed that all plants given high dosages of chlorazine died after 30 days. Dr. Gast's germination tests showed that chlorazine had extraordinary activity, but he did not observe any phytohormonal or epinastic effects. Dr. Gast recalled telephoning his test results to Dr. Knuesli in late 1952. Dr. Gast wrote a report, dated April 16, 1953, on his primary screening test results; Dr. Gysin sent a copy of this report to Ardsley. Dr. Gast recommended chlorazine for further testing; consequently, after receiving a new supply of synthesized chlorazine from Dr. Knuesli, he commenced his secondary screening and field testing in the summer of 1953. Dr. Gast's secondary screening and field tests demonstrated that chlorazine was selective toward carrots and effective as an herbicide. Dr. Gast informed Dr. Ferguson of his findings during Dr. Ferguson's visit to Geigy-Basle in October 1953. Subsequently, upon his return to Bayonne, Dr. Ferguson informed Dr. Antognini of Dr. Gast's test results.

Dr. Antognini also tested chlorazine. He commenced and completed his primary screening of the compound in January 1953. His soil germination tests showed less toxicity to radishes than to cucumbers and rye grass. His tests revealed herbicidal activity, and in contrast to Dr. Gast's not finding epinastic effects, Dr. Antognini's primary screening of chlorazine showed epinastic effects. Dr. Antognini reported his results in his herbicide-defoliant report on March 16, 1953.

Dr. Antognini also performed secondary screening and field testing of chlorazine. These were conducted in November and December 1953, on a new sample of chlorazine, which had been received from Dr. Knuesli in spring, 1953. Dr. Antognini's tests showed toxicity toward radishes but did not indicate any effects on cotton and corn at application rates as high as 16 pounds per acre. Dr. Antognini's test results were summarized in a written report on February 3, 1954.

Beginning in February 1954, Dr. Knuesli synthesized 20 triazines which were structural variations of chlorazine.[20] Dr. Knuesli's aim was to determine whether the 20 new triazine compounds would produce the herbicidal activity shown by chlorazine and to discern whether and the degree to which small structural variations in chlorazine would improve or be disadvantageous to the exhibition of herbicidal properties. In May 1954, Dr. Knuesli sent samples of these 20 new triazine compounds to Dr. Antognini and Dr. Gast for testing. Among the 20 new triazines were simazine and trietazine. Dr. Knuesli assigned code numbers G27692 and G27901 to simazine and trietazine, respectively. Simazine, like chlorazine, was a known compound when it first was synthesized by Dr. Knuesli in February 1954; however, it had no common name or did it have a known commercial use. Of the 20 sample compounds sent to Drs. Gast and Antognini in May 1954, Dr. Gast eventually proposed 8 for further testing.

The testing of simazine produced hopes that the compound would be a commercially promising herbicide. Drs. Gast and Antognini conducted primary screening tests on simazine in summer, 1954. Dr. Gast's May-1954 pre-emergent germination test showed that simazine killed all test plants. Dr. Gast telephoned these results to Dr. Knuesli in May 1954. Dr. Antognini's primary screening tests indicated herbicidal activity. His test results were sent to Geigy-Basle in a letter dated August 20, 1954. Dr. Antognini recommended in his letter that simazine be tested further as a post-emergent selective herbicide.

Although Dr. Antognini did not perform either secondary screening tests or field tests on simazine, Dr. Gast conducted extensive secondary and tertiary tests because he considered simazine a good candidate for a pre-emergent herbicide compound. Dr. Gast performed these tests at the Schweizerhalle greenhouses and fields in July and August 1954.[21] He observed that simazine persisted in soil for an extended time. Dr.

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[20] There are billions of possible triazine compounds and millions of possible chloro-triazine compounds. Not all chemists would have selected those 20 compounds chosen by Dr. Knuesli to synthesize. Some of the 20 compounds included the aryl molecular group, a feature of Dr. Gysin's original plan.

[21] Dr. Gast additionally conducted secondary contact herbicide tests on simazine and other triazines in Summer 1954. He performed watering and spraying tests for sensitivity on vines in August 1954 Simazine and other triazines were tested on garden weeds in June and August 1954.

Knuesli and Dr. Gysin visited Dr. Gast's greenhouses to observe the results of his tests. Dr. Gast reported the test results in a written statement dated December 31, 1954.

Dr. Knuesli synthesized the chemical compound atrazine from an isopropylamino group on July 26, 1955.[22] Prior to atrazine's synthesis by Dr. Knuesli, it was not a known compound. Dr. Knuesli sent atrazine samples to Dr. Gast for testing after assigning the compound code number G30027. On October 11, 1955, Dr. Gast commenced his primary screening test on atrazine. He utilized oats, rye grass, mustard, cucumbers, cotton, vetch, and sugar beets as test plants. Dr. Gast's germination tests showed extreme biological activity—all plants were killed except cotton and corn. Dr. Gast reported these results in December 1955.

In February, March, and June, 1956, Dr. Gast performed secondary screening tests and field tests on atrazine. These tests demonstrated that atrazine would be a useful herbicide leaving less soil residue than simazine. Dr. Gast reported his results on October 19, 1956.

Dr. Knuesli did not send atrazine samples to Ardsley until April 16, 1957. A reason for the delay was that, prior to Dr. Knuesli's synthesis of atrazine, Dr. Antognini terminated his position at Ardsley.

After Dr. Knuesli synthesized atrazine in July 1955, he continued to synthesize new chemical compounds. For example, he subsequently synthesized the bromo-triazine. Dr. Knuesli continued his synthesis work in the search for a chemical compound that was both an herbicide and a defoliant.

5. Patents and Governmental Registration of the Pre-Triazine and Triazine Compounds

As a result of the herbicide-defoliant project, several chemical patent applications were filed on pre-triazine chemical compounds. For example, on September 2, 1953, three Swiss patent applications covering the carbamates were filed. On December 14, 1953, a patent application covering the O-phenyl carbamates was filed in the United States. This application cited numerous examples of the use of the O-phenyl carbamates; all examples resulted from Ardsley's screening of these chemicals. The United States patent on the O-phenyl carbamates was issued on November 5, 1957. On August 23, 1954, two applications for U. S. patents for O-aryl carbamates were filed. These applications cited examples for the use of the O-aryl carbamates, all of which resulted from Ardsley's screening. The U. S. patents were issued on January 1, 1957.

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[22] Among 29 other triazine compounds that Dr. Knuesli synthesized in Summer 1955, were propazine, ipazine, simetone, and atrazine.

The first triazine patent application was filed in Switzerland on August 16, 1954, to cover the diamino-chloro-s-triazines. The Swiss application included five examples of the compounds' uses—four examples resulted from research conducted at Geigy-Basle and one example was based upon Ardsley's secondary screening of chlorazine. By August 16, 1954, Geigy-Basle had not received the test results from Ardsley on simazine. It is clear from the examples in the Swiss patent application that the geographic source of the example is irrelevant.

On June 14, 1958, the Swiss Government issued a patent covering the diamino-chloro-s-triazines, including chlorazine, simazine, and other compounds. On November 30, 1959, a supplemental application was filed with the Swiss Government to include atrazine and propazine. Of those examples listed in the supplemental Swiss patent application, one was based on Ardsley's secondary screening test of chlorazine. The Swiss supplemental patent was published on January 15, 1960.

On January 12, 1955, a patent application was filed in the United States for diamino-chloro-s-triazines.[23] The patent

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[23] Use patents on chemical compounds grant to their owners or assignees legal monopolies for one or more specific uses of known named compounds. Composition of matter patents, which are more valuable than use patents, legally protect compounds previously unknown to the scientific world. Some of the triazines synthesized by Dr. Knuesli previously had been synthesized and information on them had been published in scientific literature. Consequently, Geigy-Basle's U.S. patents on the triazines were use patents rather than composition of matter patents.

In 1952, Congress enacted 5 U.S.C. sec. 271 to codify certain aspects of prior judicially created legal doctrines of contributory patent infringement and patent misuse. The former doctrine involved the concept that a patent owner or holder should be entitled to relief against persons or organizations whose acts have facilitated patent infringement by other persons. The latter doctrine involved the concept that a patent owner or holder should be denied relief against infringers where he has attempted illegally to extend the scope of his legal patent monopoly. Congress defined the conduct which constituted contributory infringement in 35 U.S.C. sec. 3271(c), and in 35 U.S.C. sec. 271(d) specified the conduct of a patentee which was not within the scope of the patent misuse doctrine.

In the mid- and late 1950's, chemical companies were not certain whether they would run afoul of the patent misuse doctrine if they tied the sale or licensing of chemical patent rights to the application included claims that the diamino-chloro-s-triazines were suitable as active ingredients for selective as well as overall toxic weed killers. The claim also stated that the compounds were useful in defoliation and desiccation. Of the 11 examples cited in the patent application, 8 were the result of tests previously performed by Geigy-Basle and 3 were based on Ardsley's secondary screening and field tests on chlorazine. The U.S. patent covering the diamino-chloro-s-triazines was issued on June 23, 1959.

By September 1955, chloro-s-triazine patent applications had been filed in 32 countries, including the United Kingdom, France, Denmark, and Australia. Included in these patent applications were numerous examples, three of which had been taken from Ardsley's secondary screening and field tests.

Other patent applications were made in 1955. For example, on January 14, 1955, a Swiss patent application for alkoxy, alkylmercapto, and other diamino-s-triazines and their methoxy and methylmercapto derivatives was filed. On August 1, 1955, the U.S. patent application for those compounds was filed. That patent application included numerous examples for the best use of those compounds; all examples were based on prior Geigy-Basle tests. The U.S. patent was issued on October 20, 1959.[24]

After a patent application is filed and before a compound is released in a particular market for use as an herbicide, it must obtain governmental label registration. To obtain label registration, the compound must be extensively tested by cooperators in the local fields to assure the compound's effectiveness as an herbicide in the particular climate and soil and to develop dosage rates and performance and safety data. For example, after the chloro-s-triazines were covered by a pending U.S. patent application, they were released for testing to

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purchase of non-staples which had essentially no commercial usefulness outside the patented invention. Moreover, during that time, chemical companies holding patents were uncertain whether the doctrine of contributory patent infringement would be applied if they, in agreement with another, refused to license any party requesting rights under their patents. Chemical companies in the 1950s, including Geigy-Basle and Ardsley, considered these uncertainties when they negotiated the terms (including royalty rates) of various licensing arrangements regarding use patents.

In 1980, the Supreme Court resolved these issues in *Dawson Chemical Co. v. Rohm & Haas*, 448 U.S. 176 (1980).

[24] Geigy-Basle's attorneys had listed Dr. Knuesli and Dr. Gysin as the inventors of the claimed compounds on these patent applications.

U.S. cooperators. Simazine was released for testing in 1956, and atrazine was released in 1958. The various triazines were tested by universities, the USDA in Beltsville, the U.S. Department of the Interior, and the U.S. Army. Many of the cooperators included corn as a test plant.[25]

While Geigy-Basle and its licensees were responsible for obtaining European registrations of simazine, Ardsley was responsible for obtaining the U.S. registration labels for simazine and atrazine.[26] Ardsley submitted its and Geigy-Basle's test data on simazine and atrazine to the USDA and the Federal Drug Administration (FDA). The USDA issued a label registration on simazine on April 11, 1957, for use as a 50-percent wettable powder for industrial non-crop use. At that time, the USDA and the FDA rejected simazine for use as an herbicide on corn due to its lengthy soil persistence. In April 1958, simazine was approved as an herbicide for use on corn, and on December 22, 1958, the USDA approved simazine as an 80-percent wettable powder for non-crop use and use as a pre-emergent herbicide for corn. On December 1, 1958, Ardsley received the USDA label registration for atrazine as a 50-percent wettable powder for non-crop use. On January 12, 1959, Ardsley received the USDA label registration for atrazine as an 80-percent wettable powder for crop use. In March or April 1959, the USDA approved atrazine as a 50-percent wettable powder for use as a selective pre-emergent herbicide on corn. The USDA approved atrazine as an 80-percent wettable powder for use as a selective pre-emergent herbicide on corn on September 27, 1960.

6. Commercialization of Chemical Compounds Resulting From the Herbicide-Defoliant Project

Between World War II and the time the herbicide-defoliant project was undertaken, significant advances had been made to increase U.S. farm crop production; such development was largely attributable to increased mechanization on farms. Yet, farmers continued to have problems with weed control. The persistent weed problems resulted in farmers' receptiveness to the use of chemical herbicides on their fields. Consequently, more companies became involved in the creation and commercialization of herbicides; many developed a variety of preemergent and post-emergent herbicides for use on corn, a significant U.S. crop. These herbicides included, among others, 2,4-D, randox, and eptam; all were effective to some degree but all had disadvantages. For example, 2,4-D was created as a hormonal-type of herbicide to control broadleaf weeds. 2,4-D had the dominant U.S. market position as a post-emergent herbicide for corn, wheat, small grains, and cotton. The active ingredients of 2,4-D sold for approximately 40 cents per pound; the cost of treating one acre of crop with the compound was about 50 cents. The disadvantage of 2,4-D was its tendency to drift and damage nearby crops.

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[25] U.S. cooperators' tests are conducted generally free of charge. However, various expenditures are made in the process of obtaining label registration. Ardsley's estimated expenditures in order to obtain a USDA simazine registration label was approximately $5,000 to $10,000.

[26] Simazine was registered in December 1956 in Switzerland, as a selective herbicide for corn, grapes, and asparagus. Simazine was registered in 1957 in Holland for use on crops, generally. Simazine was registered as a selective herbicide in various other European countries in late 1957 and early 1958.

Randox was made by Monsanto Co. as an herbicide for controlling grasses among corn plants. However, it slightly stunted the growth of corn, and it proved difficult to handle because it caused skin and eye irritation.

Eptam was a carbamate compound made by Stauffer Chemical Co. in 1957 through 1958. Its herbicidal use was against annual grasses; it was not effective against broadleaf weeds. Corn was not tolerant to eptam's properties, and farmers found that it had a short soil duration which necessitated frequent reapplication to obtain effective results.

By the late 1950's, the U.S. corn market was the largest in the world. Approximately 83 million acres of corn had been planted, 20 million acres of which had been treated with preemergent or post-emergent herbicides. During the early and mid-1950's Geigy-Basle had seen this trend toward increased corn acreage and determined that it should enter the U.S. market by developing and commercializing a good herbicide for use on corn.

In the late 1950's, Geigy-Basle's pesticide management committee, which was authorized to select the particular chemical compounds for future commercialization, decided to release 15 patented triazine compounds for commercialization as herbicides.[27] Simazine was the first triazine commercialized. Ardsley commenced U.S. simazine sales in 1957. The commercialization of atrazine began thereafter on July 23, 1958. Initially, farmers displayed some purchasing resistance to simazine and atrazine because they were more costly treatments than 2,4-D, randox, and eptam.[28]

7. *Licensing Agreements*

By the time the triazine compounds were ready for commercialization, Geigy-Basle had established a worldwide marketing network of subsidiaries and third-party licensees to distribute its products outside Switzerland. Typically, Geigy-Basle's licensees and subsidiaries would conduct or coordinate all work to commercialize the product, including the testing of the product for governmental label registration and development and promotional work. Geigy-Basle generally restricted its worldwide third-party licensees and subsidiaries to the rights to formulate the compounds' active ingredients and to sell the finished products. Geigy-Basle normally did not grant its licensees or subsidiaries the right to manufacture the compounds' active ingredients.[29] With one exception, eventually all third-party licensing agreements with Geigy-Basle restricted licensees to the formulation and sale of specific triazines; the exception was the 1961 agreement with Nippon Kayaku Co., Ltd., which covered all triazines.

Generally, the formulation and sales licensing agreements between Geigy-Basle and its licensees obligated the licensee to pay Geigy-Basle for the purchase of the compounds' active ingredients plus a royalty, which typically equaled 5 percent of the licensee's net sales.[30] The licensees typically were granted exclusive rights to formulate and to sell the compounds in their assigned territories; however, some of the licensing agreements granted nonexclusive rights to the licensees. For instance, the licensing agreements between Geigy-Basle and Fisons of the United Kingdom, Kwizda of Austria, and Orgachemia of Luxembourg, Belgium, and the Netherlands, granted exclusive formulation and sales rights to the licensees in their specific territories. On the other hand, Societe Le Fly-Tox of France had a nonexclusive licensee in its territory, and Orgachemia had a nonexclusive licensee in Indonesia. Pursuant to the licensing agreements, the licensees generally were required to use the Geigy-Basle trademarks and name in promoting and selling the chemical compounds, including the triazines.

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[27] Among the triazines that Geigy-Basle commercialized were simazine, atrazine including terbutylazine, prometryne, ametryne, metroprotryne, terbutryne, desmetryune, dipropetryne, secbumetone, terbumetone, seputhylezine, prometone, and simetryne.

Geigy-Basle holds seven main patent cases covering the commercialized triazines. Geigy-Basle did not commercialize chlorazine, propazine, or atratone in the United States.

[28] The cost of treating one acre of crop with atrazine was approximately $2.50 if the farmer utilized the band method of treating his crops (i.e., the herbicide was applied only to the rows of crops), and $7.50 if the farmer utilized the broadcast method of application (i.e., the entire field was treated with the herbicide).

[29] The most profitable portion of the earnings derived from the sale of the chemical compounds was the part attributable to the manufacture of the compounds' active ingredients. To protect its profit-earning potential, Geigy-Basle did not want to grant its licensees and subsidiaries the right to manufacture the active ingredients for its chemical compounds.

By 1958, a number of companies, including Du Pont, Pennsalt, American Cyanamid, and American Chemical Paint Co. (AmChem) had approached Geigy-Basle to request a license to make and to distribute the triazines in the United States. AmChem would have been willing to pay a royalty of 10 to 15 percent of net sales; Du Pont would have been willing to pay a royalty of 10 to 12.5 percent of net sales. In 1958, Geigy-Basle informed potential licensees other than Ardsley that it did not intend to grant them a triazine license.

On April 29, 1958, Mr. R.T. Parker of Ardsley wrote a letter to Ardsley's attorney informing him that the USDA and the FDA granted the label registration for simazine for use on corn. Mr. Parker discussed the anticipated agricultural market for the use of simazine on corn and other crops. The letter closed with a request to Ardsley's attorney to conclude a simazine licensing arrangement with Geigy-Basle.

On May 26, 1958, Ardsley's board of directors met and resolved to sign a previously negotiated licensing agreement with Geigy-Basle which gave Ardsley the right to distribute simazine in return for royalty payments of 10 percent of net sales. The licensing agreement, entitled "Simazine Compositions and Methods License and Licensing Rights" (simazine license), dated May 1, 1958, was then signed by Mr. Zschokke

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[30] Occasionally there was a clause that escalated or decreased the royalty rate. For example, Societe Le Fly-Tox agreed to a reduction of 1 percent after 2 years of sales on all tonnage sold above an amount to be then negotiated.

Leupold for Geigy-Basle and Mr. Charles A. Suter, vice president, for Ardsley.

The simazine license between Ardsley and Geigy-Basle granted Ardsley a nonexclusive license "to make or have made for it and to sell in the United States licensed compositions." The May 1, 1958, "Simazine Compositions and Methods Licenses and Licensing Rights" agreement provided in relevant part:

> 1. The terms defined in this Section shall, for all purposes of this Agreement, have the meanings in this Section specified.
>
> (a) The term "Licensed Patent Claims" shall mean (i) the inventions claimed in United States Patent Application Serial No. 481,474, filed January 12, 1955, (ii) the claim or claims of said application or continuations or divisions thereof (excluding claims which shall have been finally rejected) and the claim or claims of United States patents that shall issue upon said application or continuations or divisions thereof, and of any reissues of said patents, and (iii) all United States patents owned or acquired by Licensor during the term of this Agreement to the extent and only to the extent that the claims thereof cover inventions falling within the scope of one or more of the claims included within the foregoing clauses (i) and (ii); all to the extent that, and subject to the conditions under which, Licensor now has or hereafter shall have the right to grant licenses, immunities or other rights thereunder.
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> * * * * * * *
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> 2. Subject to the terms and conditions of this Agreement, Licensor hereby grants to Licensee a non-exclusive, non-transferable license under the Licensed Patent Claims to make or have made for it and to sell in the United States Licensed Compositions. Said license shall extend to and authorize the use in the United States of Licensed Compositions so sold in the practice of the Licensed Methods by the purchaser or successive purchasers of such Compositions.
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> The license herein granted may be extended by Licensee to its subsidiaries, provided that each such subsidiary to which said license shall be so extended shall become bound by the terms and provisions of this Agreement to the same extent as if it were named herein as "Licensee". Licensee will itself pay and account to Licensor for royalties hereunder in respect of sales of Licensed Compositions by any such subsidiary and, for such purpose, sales of a Licensed Composition by any subsidiary (other than sales by such subsidiary to Licensee) shall be deemed to be sales by Licensee.
>
> 3. Licensee hereby grants to Licensor a royalty-free, non-exclusive, non-transferable license under all patents and patent applications of all countries owned or acquired by Licensee during the term of this Agreement to the extent and only to the extent that the claims thereof cover inventions falling within the scope of one or more of the Licensed Patent Claims. Said license may be extended by Licensor to any one or more of its subsidiaries,

other than subsidiaries of Licensee, or to any one or more of its licensees, provided that said license shall not, without the consent of Licensee, be so extended to any person, firm or corporation who shall not grant back for the benefit of Licensee hereunder a royalty-free, non-exclusive, non-transferable license under United States patents and patent applications owned or acquired by it during the term of this Agreement (or during so much of said term as said extension shall be in effect), for the same term as the license so extended, to the extent and only to the extent that the claims thereof cover inventions falling within the scope of one or more of the Licensed Patent Claims.

4. Subject to the terms and conditions of this Agreement, Licensor hereby grants to Licensee a non-exclusive right to grant, either directly or through others, non-exclusive licenses under the Licensed Patent Claims to make or have made for the licensees thereunder and to sell in the United States Licensed Compositions. Each such license so granted shall extend to and authorize the use in the United States of Licensed Compositions sold by the licensee thereunder in the practice of the Licensed Methods by the purchaser or successive purchasers of such Compositions.

5. Licenses granted by Licensee under Section 4 hereof shall be at a royalty rate not less than that provided herein in respect of the manufacture and sale by Licensee of Licensed Compositions and otherwise, in so far as appropriate, on terms substantially the same as the applicable terms of this Agreement, subject to such eliminations, variations and modifications as Licensee shall deem essential and as shall be approved by or for Licensor.

6. Each license granted by Licensee under the Licensed Patent Claims shall include a grant by the licensee of a royalty-free, non-exclusive, non-transferable license under such licensee's Improvement Patents (as hereinafter defined) for the full terms thereof inuring to the benefit of Licensor and each of its subsidiaries, provided that such cross-grant may be in respect of only the United States and may be otherwise reciprocal with grants made by Licensee to such licensee. The term "licensee's Improvement Patents" shall mean all patents and patent applications of all countries owned, acquired or controlled by such licensee during the term of the applicable license agreement, to the extent and only to the extent that the claims thereof cover inventions falling within the scope of one or more of the Licensed Patent Claims; all to the extent that, and subject to the conditions under which, such licensee shall have or may acquire the right to grant licenses, immunities or other rights thereunder.

7. (a) Licensee will pay to Licensor, in respect of Licensed Compositions sold by Licensee, a royalty at the rate of ten per cent of the net sales price (i.e., gross sales price, less discounts, returns, allowances and cost of containers included in gross sales price), f.o.b. Licensee's plant (or, if manufactured in and sold from the plant of another, f.o.b. such other plant), or all such Licensed Compositions so sold.

(b) Licensee will pay to Licensor, in respect of such Licensed Compositions sold by licensees of Licensee, an amount equal to ninety per cent of the royalties collected by Licensee or its licensing agent in respect of such sales. Licensee shall bear all expenses incurred by it in carrying out this

Agreement, the granting of licenses hereunder and the collection of royalties under such licenses.

On November 5, 1958, Ardsley's board of directors met and resolved to accept a drafted supplemental agreement to the May 1, 1958, simazine license. This supplemental agreement expanded some of the definitions of the former agreement including the definition of "licensed compositions." Otherwise, the supplemental agreement left the simazine agreement intact.

During the November 5, 1958, board of directors special meeting, Ardsley's board of directors expressed an interest in obtaining an atrazine license from Geigy-Basle. The board of directors tentatively agreed upon a royalty payment of 10 percent of net atrazine sales if Geigy-Basle would agree to grant an atrazine license. They also discussed Ardsley's need to obtain the capability to manufacture cyanuric chloride, an active ingredient of the triazines. It was suggested that Ardsley could manufacture some of the required cyanuric chloride at its McIntosh plant with the balance to be purchased from Geigy-Basle.

Simazine consists of cyanuric chloride and ethyl amino. Cyanuric chloride is manufactured from hydrocyanic acid. In 1957, Nilok Chemicals, Inc., sold cyanuric chloride in the United States for 75 cents per pound; Degussa, a European company, sold it for 56 cents per pound. By comparison, it was estimated that after obtaining the right to manufacture cyanuric chloride, Ardsley could manufacture it for 26.20 cents per pound. In 1958, Ardsley and Nilok Chemicals, Inc., negotiated an option to allow Ardsley to purchase a right to its manufacturing process for cyanuric chloride. Ardsley continued to investigate alternatives to the Nilok Chemicals, Inc., manufacturing process; it considered the manufacturing processes of Farwell Chemical Co. and Musashino Co. On April 29, 1959, Geigy-Basle signed a licensing agreement with Musashino Co. Musashino Co. granted Geigy-Basle the right to use its cyanuric chloride manufacturing process in the United States and specifically to make Ardsley the sub-licensee; the license prohibited Geigy-Basle from granting such rights to other licensees.

In 1959, Ardsley commenced construction of a cyanuric chloride manufacturing unit at its McIntosh plant. The first unit was built at a cost of $943,136, and began functioning during fall, 1960. Subsequently, between 1959 and 1968, Ardsley constructed a total of six cyanuric chloride manufacturing units at a cost in excess of $14 million.[31]

By agreement (Musashino process license) executed by Geigy-Basle and Ardsley, dated May 1, 1960, Geigy-Basle subleased to Ardsley the Musashino manufacturing process rights and the Degussa know-how regarding cyanuric chloride. The Musashino process license granted to Ardsley a nonexclusive license to use the Musashino process in manufacturing and selling cyanuric chloride in the United States. Ardsley promised to pay Geigy-Basle a royalty, as follows: (1) Two cents per pound for the first 5 million pounds of cyanuric chloride manufactured, plus (2) 1½ cents per pound for all amounts of cyanuric chloride manufactured in excess of 5 million pounds up to 8,666,667 pounds or until 5 years after Ardsley first manufactured cyanuric chloride, plus (3) 1¼ cents per pound for amounts sold or used by third parties which were not Geigy-Basle's subsidiaries. If the 5-year clause were triggered, Ardsley would be responsible for paying not less than $100,000 to Geigy-Basle. Geigy-Basle promised to engage in research and development and to make available to Ardsley all data, information, and technical know-how.

In December 1959, petitioner's board of directors authorized licenses for the triazine herbicides atratone and prometone on terms similar to the earlier simazine and atrazine agreements.

On January 1, 1961, a replacement triazine licensing agreement (replacement triazine license) was executed by Ardsley and Geigy-Basle covering U.S. patent number 2,891,855, which was issued on June 23, 1959. In pertinent part, the January 1, 1961, replacement triazine licensing agreement executed by Ardsley and Geigy-Basle included the following provisions:

> 1. The terms defined in this Section 1 shall, for all purposes of this Agreement, have the meanings in this Section 1 specified.
>
> (a) The term "Licensed Patents" shall mean (i) United States Patent No. 2,891,855, issued June 23, 1959, and any reissues thereof, (ii) all United States patents and patent applications, and transferable interests therein or rights with respect thereto, owned or acquired by Licensor during the term of this Agreement, to the extent and only to the extent that the claims

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[31] Prior to 1959, Ardsley obtained its simazine supply exclusively from Geigy-Basle. In 1959, Ardsley obtained a portion of its simazine from its Cranston, Rhode Island, facility.

thereof cover inventions falling within the scope of one or more of the claims of said Patent No. 2,891,855, and (iii) all United States patents and patent applications, and transferable interests therein or rights with respect thereto, owned or acquired by Licensor during the term of this Agreement, to the extent and only to the extent that the claims thereof cover inventions useful in connection with the manufacture of Licensed Products (hereinafter defined), including preparation or manufacture of raw materials, intermediates for or components of Licensed Products; all to the extent that, and subject to the conditions under which, Licensor now has or hereafter shall have the right to grant licenses, immunities or other rights thereunder.

* * * * * * *

(c) The term "Licensed Products" shall mean (i) compounds, compositions and products covered by one or more of the claims of the patents referred to in clauses (i) and (ii) of paragraph (a) of this Section 1, and (ii) any essential active ingredient of any of such compositions or products if and to the extent that, within the meaning of 35 U.S.C. 271(c), such ingredient constitutes a material part of the invention covered by one or more of the claims of said patents and is sold for use as a component of any such composition or product, or for use in practicing a process, so covered, but only so long as said active ingredient shall not be a staple article or commodity of commerce suitable for substantial non-infringing use.

* * * * * * *

2. Subject to the terms and conditions of this Agreement, Licensor hereby grants to Licensee an exclusive, nontransferable license under the Licensed Patents to make or have made for it and to sell in the United States Licensed Products. Said license shall extend to and authorize the use in the United States of Licensed Products so sold in the practice of the Licensed Methods by the purchaser or successive purchasers of such Products.

The license herein granted may be extended by Licensee to its subsidiaries, provided that each such subsidiary to which said license shall be so extended shall become bound by the terms and provisions of this Agreement to the same extent as if it were named herein as "Licensee". Licensee will itself pay and account to Licensor for royalties hereunder in respect of sales of Licensed Products by any such subsidiary and, for such purpose, sales of a Licensed Product by any subsidiary (other than sales by such subsidiary to Licensee) shall be deemed to be sales by Licensee.

3. Licensee hereby grants to Licensor a royalty-free, non-exclusive, nontransferable license under its Improvement Patents for all countries other than the United States to make or have made and to sell Licensed Products in such countries. Said license may be extended by Licensor to any of its subsidiaries or licensees, provided that said license shall not, without the consent of Licensee, be so extended to any person, firm or corporation that shall not grant back for the benefit of Licensee and each of its subsidiaries and licensees a royalty-free, non-exclusive, nontransferable license under its Improvement Patents for the United States of at least the same scope and term as the license so extended.

4. Subject to the terms and conditions of this Agreement, Licensor hereby grants to Licensee an exclusive right to grant, either directly or through others, non-exclusive licenses under the Licensed Patents to make or have made for the licensees thereunder and to sell in the United States Licensed Products. Each such license so granted shall extend to and authorize the use in the United States of Licensed Products sold by the licensee thereunder in the practice of the Licensed Methods by the purchaser or successive purchasers of such Products.

5. Licenses granted by Licensee under Section 4 hereof shall be at a royalty rate not less than that provided herein in respect of the manufacture and sale by Licensee of Licensed Products and otherwise, in so far as appropriate, on terms substantially the same as the applicable terms of this Agreement, subject to such eliminations, variations and modifications (other than in regard to royalty rate) as Licensee shall deem essential.

* * * * * * *

7. (a) Licensee will pay to Licensor, in respect of Licensed Products sold by Licensee, a royalty at the rate of ten percent of the net sales price (i.e., gross sales price, less discounts, returns and allowances), f.o.b. Licensee's plant (or, if manufactured in and sold from the plant of another, f.o.b. such other plant), of all such Licensed Products so sold.

(b) Licensee will pay to Licensor, in respect of Licensed Products sold by licensees of Licensee, an amount equal to ninety percent of the royalties collected by Licensee or its licensing agent in respect of such sales. Licensee shall bear all expenses incurred by it in carrying out this Agreement, the granting of licenses hereunder and the collection of royalties under such licenses.

On January 1, 1962, petitioner and Geigy-Basle entered into a consolidated replacement agreement for atratone and prometone on terms similar to the earlier replacement triazine license.

8. Sales Forecasts and Actual Sales of Simazine and Atrazine

As of February 15, 1957, the managements of Geigy-Basle and Ardsley considered simazine's commercial prospects to be promising. Mr. Parker, of Ardsley, estimated in April 1958, that sales of simazine for use solely as a corn herbicide could be "several million pounds" and within a few years could reach 10 to 15 million pounds. In September 1958, Mr. D. Burckhardt, head of Ardsley's commercial department, anticipated that the sales of simazine and atrazine by 1962 would reach $2 million and $4 million, respectively. At prices of approximately $4 to $4.50 per pound,[32] Dr. Burckhardt forecast the triazine sales between 1958 and 1962 would be as follows:

	1958	*1959*	*1960*	*1961*	*1962*
Simazine	$1,000,000	$2,000,000	$2,000,000	$2,000,000	$2,000,000
Atrazine	- - -	300,000	1,000,000	3,000,000	4,000,000
Other triazines	- - -	100,000	500,000	1,300,000	2,500,000

Ardsley's actual sales experience differed from the forecasts. In 1958, simazine sales were low as a result of abnormally low rainfall in the midwest. From 1958 through 1969, Ardsley's actual sales of simazine were as follows:

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[32] When simazine and atrazine were first introduced into the U.S. commercial market, the selling price of the formulated products was approximately $4 to $4.50 per pound of the equivalent active ingredient. The sales price of the herbicides gradually was reduced to approximately $2.50 per pound. Between 1958 and 1959, Ardsley's average annual selling prices of simazine and atrazine (on the basis of per pound of active ingredient) were as follows:

Year	*Price*
1959	NA[1]
1960	$3.49
1961	2.94
1962	2.63
1963	2.60
1964	2.56
1965	2.56
1966	2.56
1967	2.56
1968	2.56
1969	2.56

[1] Price in 1959 not lower than price in 1960.

The manufacturing costs of simazine and atrazine totaled approximately 50 cents per pound. Between 1962 and 1965, Ardsley's actual manufacturing costs of simazine and atrazine (based on per pound of active ingredient) were as follows:

Year	*Simazine cost (cents/lb.)*	*Atrazine cost (cents/lb.)*
1961	- - -	55.72
1962	53.83[1]	51.51
1963	54.35	50.89
1964	49.26	47.56
1965	41.83	39.81
1966	40.43	35.69
1967	35.47	33.68
1968	35.88	33.37
1969	35.89	30.80

[1] Cost of 96 percent technical material.

Year	*$000*	*Weight in pounds*
1958	$943	
1959	2,070	940,909
1960	1,447	450,444
1961	1,576	563,228
1962	1,995	732,679
1963	2,082	790,199
1964	2,828	1,156,693
1965	3,094	1,170,395
1966	4,160	1,574,884
1967	5,025	1,917,773
1968	5,903	2,254,525
1969	7,245	2,745,684

Atrazine proved to be a very valuable corn herbicide. It was effective as a pre-emergent and post-emergent herbicide. In contrast to simazine, atrazine did not persist in the soil for an extended time; it generally degraded by the end of corn's growing season. Atrazine was more water soluble than simazine and therefore needed less rainfall to be effective.[33] Additionally, atrazine lengthened the growing season of corn which subsequently led to an increase in corn's crop yield.

These positive features of atrazine resulted in high U. S. sales. For the period 1959[34] through 1969, Ardsley's actual sales volume in dollars and weight in pounds were as follows:

Year	*$000*	*Weight in pounds*
1959	$84	15,890
1960	2,711	788,598
1961	7,339	2,498,580
1962	13,194	5,028,745
1963	17,294	6,651,120
1964	26,001	9,931,785
1965	35,420	14,099,476
1966	53,177	21,333,263
1967	85,309	34,907,259
1968	121,905	47,849,060
1969	165,506	64,465,600

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[33] Simazine had high solubility requirements for a full effectiveness as an herbicide. Low rainfall resulted in less absorption of simazine; thus it was less effective in draught or low rainfall conditions.

[34] In 1959, Ardsley obtained its atrazine supply from Geigy-Basle.

Between 1958 and 1969, Ardsley realized gross profits on the sales of simazine and atrazine as follows:

Year	*Simazine* *$000*	*Atrazine* *$000*
1958	$407	
1959	1,029	$34
1960	564	786
1961	504	4,330
1962	818	8,972
1963	1,478	12,625
1964	2,093	19,761
1965	2,413	27,982
1966	3,216	43,605
1967	3,713	67,565
1968	4,642	99,339
1969	5,632	137,628

These earned gross profits resulted in estimated net profits before royalties, as follows:

Year	*Simazine* *$000*	*Atrazine* *$000*
1958	$22	
1959	286	$4
1960	(35)	(337)
1961	(13)	1,921
1962	222	5,030
1963	881	7,667
1964	1,096	10,596
1965	1,356	15,879
1966	1,992	27,955
1967	2,521	47,150
1968	3,222	70,009
1969	3,382	86,222

As required by the licensing agreements between Ardsley and Geigy-Basle, between 1958 and 1969 Ardsley paid royalties to Geigy-Basle based on net sales of simazine and atrazine, as follows:

Year	*Simazine royalties in $000*	*Atrazine royalties in $000*
1958	$8	
1959	205	$8
1960	145	271
1961	155	720

Year	*Simazine royalties in $000*	*Atrazine royalties in $000*
1962	$196	$1,296
1963	205	1,705
1964	279	2,563
1965	304	3,486
1966	412	5,263
1967	498	8,460
1968	582	12,029
1969	714	16,309

Simazine and atrazine were also commercially successful outside the United States. By 1959, the combined sales of simazine and atrazine reached almost 1 million pounds. By 1961, the combined sales of simazine and atrazine in Switzerland had doubled to 2.1 million pounds.[35]

As a result of licensing agreements between Geigy-Basle and its licensees and subsidiaries located outside of the United States, Geigy-Basle received royalties from the combined sales of simazine and atrazine, as follows:

Year	*Swiss Franc (SwF) × 1,000*
1959	186
1960	388
1961	912
1962	990
1963	1,408
1964	1,625
1965	1,973
1966	2,248
1967	2,398
1968	2,208
1969	2,633

Geigy-Basle realized gross profits on the worldwide (including the U.S.) sales of simazine and atrazine, as follows:

Year	*Simazine SwF × 1,000*	*Atrazine SwF × 1,000*
1959	8,060	4,676
1960	8,646	4,873
1961	8,841	5,919
1962	11,525	7,809

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[35] Simazine and atrazine were important for general weed control in England, South Africa, Canada, and other countries.

Year	*Simazine* *SwF × 1,000*	*Atrazine* *SwF × 1,000*
1963	8,652	10,795
1964	9,069	12,894
1965	8,822	12,937
1966	11,963	21,853
1967	11,322	26,759
1968	13,366	35,571
1969	16,714	57,829

9. Other Licensing Agreements Executed in the Agricultural-Chemical Field in the 1950's and early 1960's

On October 21, 1959, Geigy-Basle and Norddeutsche Affinerie (NR) entered into a contract granting NR the non-exclusive right to import, to formulate, and to sell and/or use simazine and atrazine in Germany under Geigy-Basle's trademark. Geigy-Basle promised to furnish NR full technical support and advice for the formulation, packaging, and use of the products. NR agreed to pay a royalty of 5 percent of the net sales value of the products sold. NR promised to purchase the simazine and atrazine needed for its formulations exclusively from Geigy-Basle and agreed not to resell these purchases to third parties. The contract term applied retroactively to July 1, 1957, and expired June 30, 1967.

On June 21, 1960, Geigy-Basle and Orgachemia of Holland (Orgachemia) entered into an agreement giving Orgachemia the exclusive right to formulate, package, and distribute simazine, atrazine, and propazine in the Netherlands, Belgium, and Luxembourg, and the nonexclusive right to formulate, package, and distribute those herbicides in Indonesia. Orgachemia promised to acquire the active ingredients required in its formulation exclusively from Geigy-Basle and to refrain from producing and distributing competing weed control agents. Orgachemia additionally agreed to inform Geigy-Basle of its experience with the licensed herbicides. Geigy-Basle agreed to furnish Orgachemia technical support for the formulation, packaging, and use of the simazine, atrazine, and propazine products. Orgachemia promised to pay a royalty of 5 percent of the net invoice value of the products sold without exemption for products obtained directly from Geigy-Basle and resold intact. This agreement applied retroactively to October 1, 1959, and terminated on September 30, 1967.

In 1959, Geigy-Basle and VEB Farbenfabrik Wolfen (Wolfen), an East German company, entered into an agreement granting Wolfen the exclusive right to manufacture, formulate, and sell simazine in East Germany. Wolfen agreed to pay Geigy-Basle a royalty of 6 percent of net sales. In 1962, the parties entered into a similar agreement with respect to atrazine.

On its Federal income tax returns for taxable years 1965 through 1969, petitioner claimed deductions for royalties paid to Geigy-Basle under licensing agreements covering agricultural chemical products, as follows:

Taxable year	*Amount*
1965	$7,391,309.23
1966	9,693,553.42
1967	16,469,576.43
1968	21,899,005.90
1969	25,310,686.00

Respondent disallowed a portion of the royalties relating to licensing agreements covering other agricultural chemical products, as follows:

Taxable year	*Amount*
1965	$2,075,143
1966	2,900,846
1967	4,385,237
1968	5,897,710
1969	7,949,341

In his statutory notice of deficiency respondent explained the disallowed amounts:

> For each of the years covered by this notice you engaged in transactions under licensing agreement with J. R. Geigy S. A. covering agricultural chemical products which were not at arm's length. Under the authority of section 482 of the 1954 Code royalty expenses are allocated to the extent shown. It is determined that this allocation is necessary to prevent the evasion of taxes and to clearly reflect income.

Additionally, respondent stated that the disallowed amounts constituted constructive dividends paid by petitioner to Geigy-Basle and were subject to a 5-percent withholding tax.

OPINION

For completeness, we have made exhaustive findings of facts based upon a lengthy and often engrossing trial, in which both parties made comprehensive evidentiary presentations of all matters which they deemed relevant to a determination of the relatively straightforward issue to be decided, namely, the appropriate rate of royalty, if any, to be paid by petitioner to its Swiss parent under certain licensing agreements. Despite this avalanche of data, and the inevitable very lengthy briefs which followed, we think the essential facts may be briefly but adequately summarized as we have done in the opinion which follows.

Petitioner, a New York corporation, is a wholly owned subsidiary of Ciba-Geigy, Ltd. (Geigy-Basle), a Swiss corporation. Geigy-Basle was founded in Basle, Switzerland, in 1758 as a trading company specializing in imported dyestuffs. By the early 1940's, Geigy-Basle was successfully engaged in the research and development of industrial chemicals, pharmaceuticals, and pesticides.

Geigy-Basle organized petitioner in 1909 to market and sell its products in the United States. By 1951, petitioner was engaged in the formulation and sale of agricultural chemical products and pharmaceutical products.

In 1951, pursuant to the recommendation of Dr. George Ferguson, the technical director of petitioner's insecticide department, Geigy-Basle initiated a research project to develop new defoliants and herbicides. Using a plan formulated by Dr. Hans Gysin (Dr. Gysin), the Geigy-Basle research chemist in charge of the herbicide-defoliant project, Dr. Enrico Knuesli (Dr. Knuesli), a chemist for Geigy-Basle, synthesized various chemical compounds including certain triazine compounds. These compounds were subsequently screened for herbicidal activity by Dr. Albert Gast (Dr. Gast) at the Geigy-Basle laboratory in Basle, Switzerland, and by Dr. Joe Antognini (Dr. Antognini) at petitioner's laboratory in Bayonne, New Jersey.

From 1952 through 1955, Drs. Gast and Antognini screened hundreds of triazine compounds synthesized by Dr. Knuesli. The test results of both scientists identified certain triazine compounds, including simazine and atrazine, as commercially promising herbicides. Geigy-Basle eventually filed patent applications for the triazine herbicides in more than 32 countries, including the United States.

Prior to obtaining a U.S. patent for the triazine herbicides, Geigy-Basle was required to obtain governmental label registration for any compound it intended to market in the United States as a herbicide. Petitioner agreed to perform the work necessary to obtain the U.S. registration labels for the triazine herbicides. On June 23, 1959, a U.S. patent covering the triazine herbicides was issued to Geigy-Basle.

During the late 1950's, Geigy-Basle selected 15 patented triazine compounds, including simazine, atrazine, atratone, and prometone, for commercialization as herbicides. By agreement dated May 1, 1958, Geigy-Basle granted petitioner a nonexclusive license to manufacture and sell simazine in the United States. In return, petitioner agreed to pay Geigy-Basle a royalty equal to 10 percent of net sales. In November 1958, petitioner and Geigy-Basle entered into a similar agreement with respect to atrazine.

The simazine license further provided that:

> (1) Ardsley granted a reciprocal royalty-free license to Geigy-Basle of Ardsley's improvements on the diaminochloro-s-triazine patent;
>
> (2) Ardsley had the right to extend the simazine license to subsidiaries, which would be bound by the terms of the simazine license, but Ardsley would continue to be responsible directly to Geigy-Basle for paying royalties from its own and its subsidiaries' sales of the licensed compositions;
>
> (3) Ardsley granted Geigy-Basle a royalty-free, nonexclusive, nontransferable license to cover inventions under existing and later-acquired patents and patent applications in all countries which Ardsley owned or acquired during the term of the simazine license;
>
> (4) Geigy-Basle had the right to extend the royalty-free, nonexclusive, nontransferable license covering inventions to its subsidiaries and licensees as long as the subsidiaries and licensees granted back to Ardsley a royalty-free, nonexclusive license covering their inventions;
>
> (5) Geigy-Basle granted Ardsley a right to grant nonexclusive licenses under existing patent claims; the stipulated royalty rate was to equal not less than the amount Ardsley

was obligated to pay with regard to the manufacture and sale of the licensed composition;

(6) Geigy-Basle would be entitled to a cross-grant on any improvement patents under which Ardsley licensed its licensees;

(7) Ardsley would pay Geigy-Basle a royalty of 10 percent of the net sales price (gross sales price minus discounts, returns, allowances, and costs of containers) on any licensed composition sold by Ardsley;

(8) Ardsley would pay Geigy-Basle 90 percent of royalties collected from Ardsley's sub-licensees for sales of the licensed compositions; and

(9) Geigy-Basle would make available to Ardsley all laboratory, technical, and manufacturing data regarding the licensed compositions, and Ardsley would make available to Geigy-Basle all laboratory, technical, and manufacturing data regarding the licensed compositions.

By agreement dated November 1, 1959, Geigy-Basle granted petitioner a nonexclusive license to manufacture and sell atratone and prometone in the United States. In return, petitioner agreed to pay Geigy-Basle a royalty equal to 10 percent of net sales.

By agreement dated January 1, 1961, petitioner and Geigy-Basle entered into a consolidated license agreement granting petitioner an exclusive license to manufacture and sell simazine and atrazine in the United States. Petitioner and Geigy-Basle entered into a similar agreement on January 1, 1962, granting petitioner an exclusive license to manufacture and sell atratone and prometone in the United States. Both agreements superseded the individual license agreements previously executed, and provided for a royalty of 10 percent.

These replacement triazine licenses provided in pertinent part that—(1) the license was an exclusive license allowing Ardsley "to make or have made for it and to sell in the United States Licensed Products"; (2) Ardsley was granted permission to extend the license to its subsidiaries and to successive purchasers of the licensed products; (3) Ardsley granted to Geigy-Basle a royalty-free, nonexclusive license on improvements on the U.S. patent; Geigy-Basle was permitted to extend the nonexclusive license to its subsidiaries or licensees provided that in return they were willing to extend to Ardsley a license on their improvement patents; (4) Geigy-Basle granted to Ardsley an exclusive right to grant, directly or through others, nonexclusive licenses covering the "licensed products" to make or to have them made for licensees and to sell them in the U.S.; this grant required a royalty payment at a rate of not less than provided otherwise by the replacement triazine license; (5) Ardsley promised to pay a royalty to Geigy-Basle at a rate of 10 percent of the net sales price (gross sales price minus discounts, returns, and allowances) of the "licensed products" sold; (6) Ardsley additionally agreed to pay 90 percent of that royalty amount if sub-licensees were involved; (7) Ardsley and Geigy-Basle promised to make available to one another all laboratory, technical, and manufacturing data without cost; (8) Geigy-Basle gave Ardsley the right to bring any patent infringement action at the latter's own expense.

From 1958 to 1969, petitioner paid royalties of $55,813,000 to Geigy-Basle based on net sales of simazine and atrazine in the United States. During this period, petitioner earned net profits after royalties of $231,215,000 from the sale of simazine and atrazine in the United States.

Respondent makes two arguments in this case. The first, his "principal argument," is that in 1951 Basle and Ardsley entered into a joint and cooperative research and development effort under which it would have been reasonable and logical for the two companies to share equally the fruits of their research by providing for a geographical division of the market, thus requiring a royalty-free license. This issue, and the resultant increases in deficiency and withholding liability, was raised for the first time in respondent's amendment to answer. The statutory notice of deficiency simply reduced the royalty payable from 10 percent to 6 percent under the 1961 and 1962 licenses. Respondent concedes that he has the burden of proof on the increased deficiencies and withholding liabilities. See Rule 142(a).

Respondent's alternative argument, which is the issue raised by the notice of deficiency, is that under the criteria contained in section 1.482–2(d)(2), Income Tax Regs., a rate of royalty in an amount less than the 10 percent claimed by petitioner would have been arrived at in arm's-length negotiations between unrelated parties.

Petitioner argues that an unrelated party would have paid a royalty of 15 percent for similar rights under the triazine patents. Petitioner therefore concludes that it is entitled to apply the difference between a royalty of 15 percent and a royalty of 10 percent as a setoff against other section 482 allocations which have been settled by the parties.

After careful consideration of the record before us, we are convinced that a royalty of 10 percent constituted an arm's-length consideration for the exclusive right to manufacture and sell the triazine herbicides in the United States. We also conclude that petitioner is not entitled to an additional setoff for royalties in excess of 10 percent.

Section 482[36] empowers respondent to allocate gross income, deductions, credits, or allowances between commonly controlled organizations if he determines that such allocation is necessary to prevent evasion of taxes or to clearly reflect the income of such organizations. The purpose of section 482 is to place a controlled taxpayer on a parity with uncontrolled, unrelated taxpayers. *Huber Homes, Inc. v. Commissioner*, 55 T.C. 598, 605 (1971); sec. 1.482-1(b)(1), Income Tax Regs. The critical inquiry is whether the transaction in question would have been similarly effected by unrelated parties dealing at arm's length. Sec. 1.482-1(b)(1), Income Tax Regs.

Respondent has considerable discretion in applying section 482 and his determination must be sustained unless that discretion has been abused. *Grenada Industries, Inc. v. Commissioner*, 17 T.C. 231 (1951), affd. 202 F.2d 873 (5th Cir. 1953). Petitioner generally bears the burden of proving that respondent abused his discretion in applying section 482. Petitioner therefore must prove that respondent abused his discretion in reducing the royalty payable under the 1961 and 1962 triazine license agreements from 10 percent to 6 percent. *Nat Harrison Associates, Inc. v. Commissioner*, 42 T.C. 601 (1964). Because respondent, in his amended answer, seeks to disallow the previously allowed royalties paid by petitioner to Geigy-Basle, respondent bears the burden of establishing that no royalty should have been payable under the triazine licenses in issue. *Achiro v. Commissioner*, 77 T.C. 881, 890 (1981).

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[36] Sec. 482, as in effect for the years in issue, provides as follows:

"In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

Basically, respondent asks us to apply a rather generalized facts and circumstance approach to the disposition of this case rather than a precise analysis under the relevant part of the section 482 regulations (sec. 1.482–2(d), Income Tax Regs.). Certainly a first glance at the continuing contacts between the Swiss and U.S. companies on the herbicide project first suggested by Dr. Ferguson in 1950 might lead one to suppose that the respective contributions of the two companies to the ultimate triazine discoveries were significant, and that the resulting patents were in substance, if not in legal fact, the joint property of both companies which they were equally entitled to exploit. Unfortunately for respondent's case, a closer scrutiny of the facts makes this supposition unsupportable insofar as petitioner's contribution is concerned.

By placing his main emphasis on his joint venture theory, respondent attempts to deflect the thrust of his own "Transfer or use of intangible property" regulations (cited *supra*) which to respondent's discomfiture fit this case like a glove. The evidence is overwhelmingly convincing that the success of the project (which produced 1963–69 net profits for petitioner after royalties—all subject to U.S. corporate income tax—of $227,119,000) was essentially attributable to Geigy-Basle. And it is upon the development of the triazine compounds, and not the exploitation of the U.S. market for them, that we must keep our attention focused. As the record amply makes clear, it was the foresightedness of Dr. Charles Koechlin (the chief executive officer of both Geigy-Basle and petitioner) in consistently encouraging the project, the imagination, energy, and scientific skills of Drs. Gysin and Kneusli in making the discoveries, and the imposing scientific resources, both in human and physical terms, which Geigy-Basle could bring to bear to support the necessary research, which made the project's almost unqualified success an eventuality.[37] Geigy-

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[37] As stated in our findings of fact, by 1950, Geigy-Basle's research staff included approximately 50 Ph.D. synthetic chemical specialists and their support staffs. It was not until the mid-1950's that personnel at petitioner's laboratory (located in Bayonne, New Jersey) engaged in basic research, chemical synthesis, primary screening, or micronanalytical work.

Basle's scientific resources were imposing by any standards; petitioner's, in the early 1950's, did not exist.

It was evident from the outset of the project in 1951 that the research in question could not be attempted in the United States, although Dr. Ferguson initially suggested that it could be—at an annual budget of $30,000. Petitioner's contribution to the research, centered wholly in the essentially duplicative testing by Dr. Antognini, in Bayonne, of compounds chemically formulated and simultaneously tested biologically in Switzerland, was peripheral at best. We return to a discussion of this point subsequently herein.

In his fallback position, respondent argues that if we do find the intangible property regulations (sec. 1.482–2(d), Income Tax Regs.) to be applicable, then we should determine "an appropriate arm's length royalty." Although respondent's deficiency notice determined a 6-percent rate of royalty, on brief he does not specify what he now deems to be an appropriate arm's-length royalty, except that it should be "a royalty rate substantially below the range of the industry norm of about 5 percent if an exclusive license was granted and approximately one-half that for a non-exclusive license." If we decipher that language correctly, respondent suggests a rate of 3¾ percent.

Section 1.482–2(d), Income Tax Regs., provides a framework for determining an arm's-length consideration for the transfer, sale, assignment, or loan of intangible property or an interest therein between members of a group of controlled entities. Section 1.482–2(d)(3)(ii)(*a*), Income Tax Regs., specifically identifies "patents" as intangible property. We therefore will apply section 1.482–2(d), Income Tax Regs., in making our inquiry as to an arm's-length consideration for the rights petitioner received under Geigy-Basle's U.S. triazine patents.

Section 1.482–2(d)(2)(ii), Income Tax Regs., defines an arm's-length consideration as "the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances." The above section further provides that the best indication of an arm's-length consideration is the amount paid by an unrelated party for transfers involving the same or similar intangible property under the same or similar circumstances. In the absence of a sufficiently similar transaction involving an unrelated party, section

1.482-2(d)(2)(iii), Income Tax Regs., lists the following factors as relevant in determining the amount of an arm's-length consideration:

> (a) The prevailing rates in the same industry or for similar property,
>
> (b) The offers of competing transferors or the bids of competing transferees,
>
> (c) The terms of the transfer, including limitations on the geographic area covered and the exclusive or non-exclusive character of any rights granted,
>
> (d) The uniqueness of the property and the period for which it is likely to remain unique,
>
> (e) The degree and duration of protection afforded to the property under the laws of the relevant countries,
>
> (f) Value of services rendered by the transferor to the transferee in connection with the transfer within the meaning of paragraph (b)(8) of this section,
>
> (g) Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property,
>
> (h) The capital investment and starting up expenses required of the transferee,
>
> (i) The next subdivision is (j),
>
> (j) The availability of substitutes for the property transferred,
>
> (k) The arm's length rates and prices paid by unrelated parties where the property is resold or sublicensed to such parties,
>
> (l) The costs incurred by the transferor in developing the property, and
>
> (m) Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.

We therefore must first determine whether the record contains a sufficiently similar transaction involving an unrelated party.

Petitioner points to the license agreements entered into between Geigy-Basle and Norddeutsche Affinerie of Germany and Orgachemia of Holland as transfers involving the same or similar intangible property under the same or similar circumstances. Respondent disagrees, arguing that the license agreement entered into between Geigy-Basle and VEB Farbenfabrik Wolfen (Wolfen) of East Germany is the only sufficiently similar transaction involving an unrelated party. For the reasons stated below, we disagree with both parties.

Geigy-Basle granted Norddeutsche Affinerie the nonexclusive right to formulate and sell simazine and atrazine in Germany. Orgachemia received the exclusive right to formulate and sell simazine, atrazine, and propazine in the Netherlands, Belgium, and Luxembourg, and the nonexclusive right to formulate and sell those herbicides in Indonesia. In return, Norddeutsche Affinerie and Orgachemia agreed to pay Geigy-Basle a royalty of 5 percent and to purchase the active ingredients for the triazine herbicides from Geigy-Basle.

Petitioner argues that, because the markup on the sale of the active ingredients plus the 5-percent royalty at least equals the 10-percent royalty paid by them, these third-party license agreements confirm the arm's-length nature of the royalty payments in issue.

Although we agree that these third-party license agreements represent transfers involving "the same or similar intangible property," we do not believe that these transfers occurred under "the same or similar circumstances" as the transfers at issue in the instant case. Unlike the licenses herein granting petitioner the right to manufacture the active ingredients for the triazine herbicides, the license agreements with Norddeutsche Affinerie and Orgachemia require them to purchase the active ingredients for the triazine herbicides from Geigy-Basle. Thus, petitioner was required to make substantial capital investments and assume large risks in connection with the production of the active ingredients for the triazine herbicides (see pp. 207–208, *supra*), while Norddeutsche Affinerie and Orgachemia were afforded the relatively risk-free obligation of only having to purchase the triazine herbicides that they sold. We therefore find that these third-party licenses are not "sufficiently similar transactions" as contemplated by section 1.482–2(d)(2)(ii), Income Tax Regs.

It might be argued that petitioner's obligation to make substantial capital investments and assume large risks militates in favor of a royalty rate no greater than the Orgachemia 5-percent rate and that this factor supports respondent's case. This "same or similar" factor is neutralized, however (as we discuss *infra* at pp. 229–230), by the more than offsetting increased profits generated by petitioner's capital investment in six cyanuric chloride manufacturing units constructed by petitioner from 1959 through 1968 pursuant to the provisions of the relevant agreements which permitted petitioner to manufacture the active ingredients of the triazine compounds. These augmented profits far exceeded the capital costs of producing them.

Respondent argues that the license agreements entered into between Geigy-Basle and Wolfen are sufficiently similar to the license agreements in issue to establish an arm's-length consideration. In 1959, Wolfen agreed to pay Geigy-Basle a royalty of 6 percent of net sales for the right to manufacture, formulate, and sell simazine in East Germany. In 1962, the parties entered into a similar agreement with respect to atrazine. The record, however, contains no evidence supporting respondent's contention that the Wolfen license was granted under circumstances similar to those existing when the triazine licenses in issue were granted. Indeed, respondent admitted on brief that "the totality of circumstances surrounding the negotiation of [the Wolfen] license are unclear." In the absence of evidence establishing that the Wolfen license was granted under circumstances similar to the instant case, we refuse to rely on this agreement as evidence of an arm's-length consideration.

Having found that the record does not contain a sufficiently similar transaction involving an unrelated party, we must look to the relevant factors identified by section 1.482-2(d)(2)(iii), Income tax Regs. Section 1.482-2(d)(2)(iii)(*b*), Income Tax Regs., provides that we may consider "the offers of competing transferors or the bids of competing transferees" in arriving at the amount of an arm's-length consideration. In 1957 and 1958, Albert Griggs (Griggs), a senior patent attorney for Du Pont's industrial and chemical department, negotiated with Geigy-Basle on Du Pont's behalf. On both occasions, Du Pont offered to pay Geigy-Basle a royalty of 10 to 12.5 percent of net sales for the nonexclusive right to manufacture, formulate, and sell the triazine herbicides in the United States. Although Geigy-Basle eventually rejected Du Pont's offer, we are satisfied that this offer is highly probative of the amount an unrelated party would have paid for the same intangible property under similar circumstances.

Respondent argues that Griggs did not have the authority to commit Du Pont to a certain royalty rate. Respondent contends that Du Pont required its patent board to approve all licensing agreements. Respondent thus concludes that because Du Pont's patent board never approved Griggs' offer, we should not rely on this offer as indicative of an arm's-length consideration. We are unpersuaded by this argument.

Although Griggs agreed that Du Pont required its patent board to approve all license agreements, he testified that the board's approval was a mere formality. Griggs noted that prior to the negotiations with Geigy-Basle, he had committed Du Pont to numerous licensing agreements. He also stated that he had never submitted an agreement to the board that was questioned or turned down because of the royalty rate included in the patent license. Indeed, Griggs testified that he could have offered to pay a royalty of 15 percent for the triazine patent license without obtaining the prior consent of Du Pont's management.

We find Griggs' testimony candid, forthright, and credible. Consequently, we are convinced that Du Pont's offer to pay at least 10 percent for a license under Geigy-Basle's triazine patent was bonafide and therefore establishes that an unrelated party would have paid a royalty of at least 10 percent for the triazine agreements in issue. In so holding, we note that Griggs' authorization to offer a royalty of 15 percent for a triazine license is sufficient to overcome respondent's contention that Griggs' offer of 10 percent was not bonafide. The record, however, contains no evidence that Du Pont actually offered 15 percent for a triazine license. We therefore do not find this testimony sufficient to support petitioner's contention that a royalty of 15 percent constituted an arm's-length consideration.

The profit potential of the triazine herbicides is further evidence that a royalty of 10 percent constituted an arm's-length consideration for the exclusive right to manufacture, formulate, and sell the triazine herbicides in the United States. Sec. 1.482–2(d)(2)(iii)(*g*), Income Tax Regs. In the late 1950's, independent researchers throughout the United States described the triazine herbicides, especially simazine and atrazine, as more effective than any other corn herbicide available in the United States. In 1958, based on the triazines' superiority as corn herbicides petitioner's management projected that, by 1962, the sales of simazine and atrazine would reach $2 million and $4 million, respectively. Petitioner's management also projected that the triazine herbicides' low production costs would result in a gross profit percentage with respect to triazine sales of almost 80 percent.

By 1961 and 1962, when petitioner entered into the consolidated license agreements in issue, the sales performance of the triazine herbicides had confirmed their projected profitability. In 1961, petitioner experienced simazine and atrazine sales of $1,576,000 and $7,339,000, respectively. Despite substantial capital expenditures in that year to purchase equipment to produce the active ingredients for the herbicides, petitioner realized net profits after royalties of $1,033,000 from the sale of simazine and atrazine in the United States. By 1962, petitioner's net profits after royalties totaled $3,760,000 on sales of simazine and atrazine in the United States.

After 1962, the sales volume and profitability of the triazine herbicides exceeded petitioner's initial projections. From 1963 through 1969, petitioner earned net profits after royalties of $227,119,000 from the sale of simazine and atrazine in the United States. Thus, we are convinced that at the time petitioner and Geigy-Basle entered into the triazine agreements in issue (1961 and 1962), an unrelated third party would have been willing to pay a royalty of 10 percent for similar triazine licenses in light of the triazines' program as well as projected profitability. Indeed, Du Pont recognized the substantial profit potential of the triazines as early as 1958 when it offered a royalty of at least 10 percent for a similar triazine license.

A third factor which may be considered in determining the amount of an arm's-length consideration is "the prevailing rates in the same industry." Sec. 1.482-2(d)(2)(iii)(*a*), Income Tax Regs. Respondent argues that because prevailing rates for an exclusive license in the agricultural chemistry industry ranged from 3 to 6 percent of net sales during the 1950's, a royalty of 10 percent for an agricultural chemical product could not constitute an arm's-length consideration. Assuming that 3 to 6 percent represents a royalty norm for the agricultural chemical industry during the 1950's, we are nevertheless unpersuaded by respondent's argument.

A norm represents an industry average. Reports from various research facilities throughout the world during the 1950's, however, established that the triazine herbicides did not represent an average product in the agricultural chemical industry. Both petitioner and Geigy-Basle projected the enormous profit potential of the triazine herbicides prior to entering into the license agreements in issue. Indeed, the triazines' actual profitability by the time of the relevant agreements far exceeded petitioner's most optimistic projections.

Moreover, respondent repeatedly emphasized throughout his briefs that, as a rule of thumb, a royalty rate generally divides net profits before royalties 25 to 75 percent between the licensor and licensee, respectively. From 1958 to 1969, petitioner earned net profits before royalties of $287,028,000 from the sale of simazine and atrazine in the United States. During this same period, petitioner paid royalties of $55,813,000 to Geigy-Basle, pursuant to the simazine and atrazine license agreement in issue. Consequently, petitioner retained more than 80 percent of the net profits before royalties earned from the sale of simazine and atrazine in the United States. Thus, under the rule of thumb emphasized by respondent, petitioner retained more than a reasonable amount of net profits from the sale of the triazine herbicides.

Section 1.482–2(d)(2)(iii)(*h*), Income Tax Regs., provides that "The capital investment and starting up expenses required of the transferee" is another factor which should be considered when arriving at the amount of an arm's-length consideration. Respondent contends that a 10-percent royalty failed to reflect the amount of capital petitioner anticipated investing in equipment to manufacture cyanuric chloride, an active ingredient of the triazine herbicides. We disagree.

In 1960, petitioner paid $943,136 to construct its first cyanuric chloride manufacturing unit. In 1957, it had been estimated that petitioner's production of cyanuric chloride would reduce the triazines' manufacturing costs by approximately 50 cents per pound. Based on a 1958 estimate that simazine sales alone would reach 10 to 15 million pounds within a few years, petitioner's production of cyanuric chloride would result in additional profits of at least $5 million to $7 million, annually. Under the triazine license agreements in issue, petitioner would retain 90 percent of these additional profits. On the record before us, we are convinced that an unrelated third party would have considered these additional profits a more than adequate return on its investment after paying a royalty of 10 percent to Geigy-Basle.

Indeed, as a result of the triazines' commercial success, petitioner constructed six cyanuric chloride manufacturing units from 1959 through 1968 at a cost in excess of $14 million. From 1959 through 1969, petitioner sold 221,866,789 pounds of simazine and atrazine. Thus, petitioner realized additional profits of at least $99,840,055 from its $14 million investment. Consequently, we are convinced that the 10-percent royalty adequately reflects petitioner's anticipated capital expenditures with respect to the production of cyanuric chloride.

Having determined that a royalty of 10 percent constitutes an arm's-length consideration under the factors identified in section 1.482-2(d)(2)(iii), Income Tax Regs., we now return to respondent's principal argument that in 1951, petitioner and Geigy-Basle entered into a joint research project to develop new herbicides and defoliants. Respondent maintains that petitioner's agreement, at an October 2, 1951, meeting attended by representatives from both petitioner and Geigy-Basle, to perform, without compensation, parallel screening and field testing of certain chemical compounds synthesized by Geigy-Basle and to assume responsibility for the U.S. label registration of any patentable compounds subsequently discovered, establishes the existence of a joint research and development project between petitioner and Geigy-Basle.[38]

Respondent's argument, while ardently propounded, is a valiant effort to make bricks without straw. The record simply does not support the proposition that petitioner contributed significantly to the research that led to the successful development of the triazine compounds. Respondent contends that the relevant inquiry is how unrelated members of a joint research and development project dealing at arm's length would have agreed to share the potential benefit of their joint effort in 1951. Based on the facts that existed in 1951, respondent concludes that it would have been reasonable for petitioner and Geigy-Basle to share the potential benefits on the basis of a royalty-free geographical division of world-wide markets, petitioner receiving the U.S. market. Respondent's argument might have merit if his premise that petitioner and Geigy-Basle entered into a joint research and development project were sound. For the reasons stated below, however, we are not convinced that petitioner and Geigy-Basle entered into such a project in 1951.

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[38] We note that although respondent's regulations deal specifically with a "bonafide cost sharing arrangement" under a section entitled "Sharing of costs and risks" (sec. 1.482-2(d)(4), Income Tax Regs.), respondent makes no mention of this section in his brief. The regulation does not permit *taxpayers* to claim to have entered into a cost sharing arrangement unless the arrangement has been reduced to writing.

Petitioner's agreement to perform certain services without compensation does not create a joint research and development project entitling petitioner to receive the royalty-free right to manufacture, formulate, and sell the triazine herbicides in the United States. Respondent does not contend, nor does the record contain any evidence, that petitioner and Geigy-Basle expressly agreed to share the costs and potential benefits of the herbicide-defoliant project. Cf. sec. 1.482–2(d)(4) (Sharing of Costs and Risks). Rather, respondent contends that we should imply these terms from the parties' course of conduct pursuant to an arm's-length standard. In the absence of more persuasive evidence that petitioner and Geigy-Basle impliedly intended to share the costs and benefits of developing new herbicides and defoliants, we refuse to write a joint venture agreement for them.

We nevertheless agree that petitioner did not receive compensation from Geigy-Basle for the performance of certain services in connection with field testing, parallel screening, and registration of the triazine herbicides in the United States. Section 1.482–2(d)(1)(ii)(*b*), Income Tax Regs., however, specifically addresses the allocation of an arm's-length consideration for the performance of services in connection with an attempt to develop intangible property. Section 1.482–2(d)(1)(ii)(*b*), Income Tax Regs., provides as follows:

> Where one member of a group renders assistance in the form of * * * services * * * to a developer in connection with an attempt to develop intangible property, the amount of any allocation that may be appropriate with respect to such assistance shall be determined in accordance with the rules of the appropriate paragraph or paragraphs of this section.

Thus, if we determine that Geigy-Basle was the developer of the U.S. triazine patent, we must look to section 1.482–2(b) (Performance of services for another), Income Tax Regs., to determine the amount, if any, we should allocate as an arm's-length charge for services rendered by petitioner in connection with the development of the triazine herbicides.

Section 1.482-2(d)(1)(ii)(*c*), Income Tax Regs., provides that:

> The determination as to which member of a group of related entities is a developer and which members of the group are rendering assistance to the developer in connection with its development activities shall be based upon all the facts and circumstances of the individual case. Of all the facts and circumstances to be taken into account in making this determination, greatest weight shall be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group * * *. Other factors that may be relevant * * * include the location of the development activity, the capabilities of the various members to carry on the project independently, and the degree of control over the project exercised by the various members.

Relying on the factors identified above, we find that Geigy-Basle was the developer of the U.S. triazine patent.

Although the record contains little evidence of the relative costs and corresponding risks borne by petitioner and Geigy-Basle in the development of the triazine compounds, the overall planning and supervision of the herbicide development, the synthesis of the chemical compounds and a very substantial part of the biological screening of those compounds occurred in Switzerland. And, although petitioner performed some biological screening and field testing in the United States, the significant development activities, including biological screening, were performed by Geigy-Basle in Switzerland.

Moreover, only Geigy-Basle was capable during the development years of independently carrying on the development of new herbicides. Geigy-Basle could have contracted with one of several U.S. companies to perform biological screening at a modest cost. See discussion *infra*. In addition, potential third-party licensees would have performed field testing and assumed responsibility for U.S. label registration of any commercially promising compound. Indeed, the parties stipulated that Geigy-Basle "had all the facilities and services needed to undertake a research project in the herbicide field." The record establishes, however, that petitioner possessed neither the laboratory facilities nor the personnel needed to undertake a herbicide development project during the 1950's.

Finally, Geigy-Basle planned the synthesis program, selected the chemical compounds to be screened for biological activity, and determined which compounds would be commercialized. Thus, Geigy-Basle exercised full control over the research and development of the triazine herbicides.

Consequently, we find that Geigy-Basle was the developer of the U.S. patents for the triazine herbicides.

Having determined that Geigy-Basle was the developer of the U.S. patent for the triazine herbicides, we now turn to section 1.483–2(b), Income Tax Regs., to determine the appropriate allocations to reflect an arm's-length charge for petitioner's services. Section 1.482–2(b)(1), Income Tax Regs., provides:

> Where one member of a group of controlled entities performs marketing, managerial, administrative, technical, or other services for the benefit of, or on behalf of another member of the group without charge, or at a charge which is not equal to an arm's length charge as defined in subparagraph (3) of this paragraph [Section 1.482–2(b)(3), Income Tax Regs.], the district director may make appropriate allocations to reflect an arm's length charge for such services.

Section 1.482–2(b)(2), Income Tax Regs., in relevant part provides:

> (2) *Benefit test.* (i) Allocations may be made to reflect arm's length charges with respect to services undertaken for the joint benefit of the members of a group of controlled entities, as well as with respect to services performed by one member of the group exclusively for the benefit of another member of the group. Any allocations made shall be consistent with the relative benefits intended from the services, based upon the facts known at the time the services were rendered, and *shall be made even if the potential benefits anticipated are not realized.* * * * [Emphasis added.]

Section 1.482–2(b)(3), Income Tax Regs., defines an arm's-length charge for services rendered as "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between related parties under similar circumstances considering all relevant facts." Section 1.482–2(b)(2)(ii), Income Tax Regs., states, however, that:

> Allocations will generally not be made if the service is merely a duplication of a service which the related party has independently performed or is performing for itself. In this connection, the ability to independently perform the service (in terms of qualification and availability of personnel) shall be taken into account.

Consideration of the entire record leads us to conclude that as events unfolded the screening performed by Dr. Antognini proved in fact to be a duplication, but at the time the herbicide project began, both Geigy-Basle and petitioner thought the biological screening in New York would be useful. Nevertheless, petitioner's contribution to the ultimate development of the triazine compounds was extremely circumscribed.

The record reveals that Joe Antognini was a doctoral candidate at Cornell in May or June of 1950 when he was hired to perform biological testing of the compounds to be sent to him from Basle. The tests which he perfectly competently performed were nonetheless standard tests which were in no way innovative or unique, and could equally well have been performed on a contract basis by an independent laboratory such as the Boyce Thompson Institute whose director, Dr. Torgeson, testified at trial.

Dr. Antognini performed his tests in the Bayonne laboratory in almost complete isolation from the ongoing research in Basle. He never visited the research facilities in Basle. He testified that he never conferred by telephone with anyone in Basle. By contrast Dr. Gast, the eminently skilled and experienced biologist in Basle, conferred constantly with Drs. Kneusli and Gysin. If for no other reason, this followed from Dr. Gast's close physical proximity to the two research chemists and their staffs.

Dr. Antognini forwarded his reports to Basle by mail, but the testimony of various witnesses at the trial on this point, which we found entirely consistent and credible, reflects a pattern of rapidly ongoing progress in the triazine research, unhampered by the inevitable delays in delivery of Dr. Antognini's reports.

In a February 2, 1960, speech, Dr. Gysin stated that "We used this double-check procedure for more than two years when it became evident that the agreement between the test-laboratories had reached such a perfection that we could give up the screening work in New York." The screening results of the tests performed by Dr. Antognini in the United States and Dr. Gast in Switzerland were very similar. Both scientists used well-established screening methods designed to discover chemical compounds exhibiting herbicidal activity. Although petitioner and Geigy-Basle did not use identical test methods, Dr.

Melville Hillman, respondent's expert witness, testified that "in all of the really important cases, Gast and Antognini agreed."

Indeed, because of the similarity of the screening results, Dr. Antognini terminated his screening activities in 1955 and left the employ of petitioner. A 1955 annual report for the herbicide-defoliant program explained the basis for the decision as follows:

> This decision was based on the fact that the screening results from Bayonne and Switzerland were so closely in line that it was felt that time and expense could be saved if only one laboratory did the screening.

Dr. Torgeson, director of pesticide screening at the Boyce Thompson Institute, testified at trial that he believed duplication screening tests "would be redundant, almost a waste of resources to do so."

In addition to performance of the double check referred to by Dr. Gysin in his speech, Dr. Antognini's tests formed the basis for a few examples in the Swiss and U.S. patent applications, although most of the examples derived from Dr. Gast's tests. Dr. Antognini also was the first to note the epinastic effect of chlorazine on certain plants tested by him.

There was testimony at the trial to the effect that the Boyce Thompson Institute would have tested the compounds which Dr. Antognini tested at a cost of between $30 and $50 per compound. It also appears that Dr. Antognini tested approximately 425 compounds in connection with his primary screening and an additional 172 compounds in connection with his secondary screens. As previously stated, Treas. Regs. section 1.482-2(b)(2)(i) provides that allocations may be to reflect arm's-length charges with respect to services undertaken for the joint benefit of the members of a group of controlled entities. This section of the regulations permits such an allocation "even if the potential benefits anticipated are not realized." Section 1.482-2(b)(2)(i) of the regulations provides that allocations will *generally* not be made for services which are duplicative, but we assume this recognizes that in some situations some allocation should be made in spite of duplication.

In any event, notwithstanding the fact that the services performed by Dr. Antognini eventually proved to be duplicative and of limited overall significance, we think some allocation should be made to reflect these services. In the absence of concrete cost data, and using our best judgment based upon our evaluation of all of the relevant facts and circumstances, we find that $100,000 should be allocated as petitioner's contribution to the development of the licensed triazine compounds. We further hold that the value of these services should be allocated equally between the 1961 and 1962 licenses over the respective terms thereof, as setoffs against royalty payments thereunder.

With respect to field testing and petitioner's work to obtain label registration in the United States, the record establishes that a third-party licensee under similar circumstances would not have received compensation for the performance of these services. Mr. Griggs of Du Pont testified at trial that if his company had received a license under the triazine patents in exchange for a royalty of 10 percent, Du Pont would have performed field testing and any work necessary to obtain U.S. label registration for the triazines at its own expense. Griggs explained that "a good deal of the inducement which we had for Geigy to work with us, was our capability to test, to get clearance by the Food and Drug Administration, to get the product on the market. That was what we had to offer."

Moreover, Du Pont's willingness to perform these services without compensation was typical of the policies and practices of the agricultural chemical industry. In the 1950's, it was standard practice for licensees of pesticide products to carry out or coordinate all the development work necessary for commercialization of the products in their respective markets. Licensees were generally responsible for field testing and any additional work necessary to obtain label registration in their respective markets, all at their own expense. Indeed, the record contains numerous examples of prospective third-party licensees under the triazine patents, performing field tests and other work necessary to obtain label registration at their own expense. Accordingly, we are convinced that a potential third-party licensee would not have received compensation for services performed in connection with field testing and label registration in the United States.

In conclusion, for the reasons stated above, we find that petitioner has satisfied its heavy burden of proving that respondent's reduction of the royalty from 10 percent to 6 percent paid by petitioner during the years in issue constituted an abuse of discretion, and that respondent has failed to carry his burden of proving that no royalty payment is allowable. On the record before us, however, we decline to find that a royalty in excess of 10 percent would constitute an arm's-length consideration. The testimony of representatives for both petitioner and Geigy-Basle was that the parties ultimately agreed to a 10-percent royalty rate only after engaging in substantial negotiations. We perceive no reason to gainsay that testimony by modifying the terms of an agreement which resulted from the parties' self-styled good-faith bargaining.[39] Furthermore, as abundantly demonstrated, the 10-percent royalty is completely consistent with the testimony of Mr. Griggs of Du Pont subject only to the $100,000 allocation for services performed by petitioner previously discussed.

To reflect the foregoing and prior concessions,

Decision will be entered under Rule 155.

DONALD L. HERRICK AND MARJORIE P. HERRICK, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 3649–83. Filed August 5, 1985.

Petitioner executed the required paperwork to acquire a TireSaver (a tire pressure monitoring system) distributorship. Petitioner also elected to distribute the combination TireSaver and radar detector system. Petitioner delivered: (1) A check, in the amount of $36,834.99, as payment of the acquisition fee ($35,233.47), and the promotional expense for 1978 ($1,601.52); (2) a $147,339.97 nonrecourse promissory note as payment of the annual use fee for 1978; (3) a $36,834.99 nonrecourse promissory note as partial payment (two-thirds) of the annual use fee for 1979; (4) a $17,616.74 recourse promissory note as partial payment (one-third) of the annual use fee for 1979, to LSI, as promoter. Petitioners claimed a $150,863.77 loss, ($3,523.80 of depreciation, and $147,339.97 as annual use fee) from the distributorship activity on their 1978 income tax return, and a $33,316 loss ($3,524 of depreciation, $16,496 interest deduction, and $13,296 of annual use fee) for 1979. *Held*: Petitioners have failed to carry their burden of proving that they entered into the TireSaver activity with the primary and predominant objective of realizing an economic profit. Therefore, petitioners are not entitled to deduct under secs. 162(a) and 1253(d)(1), I.R.C. 1954, any part of the nonrecourse and recourse notes delivered as payment of annual use fees for 1978 and 1979. *Held, further*, petitioners are not entitled to deduct interest expense for 1979, as the use of the exclusive right to distribute the combination TireSaver and radar detector system was impracticable; no gross profits were ever generated as no TireSaver products were manufactured; the underlying liabilities were not binding and enforceable, were contingent, and petitioner did not reasonably believe that the liabilities would be paid, therefore the interest was improperly accrued; and petitioners failed to prove that the purchase price and the principal amount of the nonrecourse note do not unreasonably exceed the value of the distributorship. *Held, further*, petitioners are not entitled to depreciation or amortization deductions for 1978 and 1979 with respect to the distributorship acquisition fee under sec. 1253(d)(2)(A), as a trade or business is required in order for such deductions to be allowed. *Held, further*, sec. 183(b)(2) is of no benefit to petitioners as no gross income was generated by the activity.

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[39] At trial, respondent attempted to introduce into evidence petitioner's post-trial brief submitted in *Ciba-Geigy Corp. v. Farmland Industries, Inc.*, an administrative proceeding brought by petitioner before the Environmental Protection Agency. Because we found the possibility of prejudice outweighed the brief's potential usefulness, we refused to admit the brief into evidence. On brief, respondent argues that our ruling was erroneous. Having ruled on the admissibility of the brief at trial, we need not and do not reconsider the admissibility of the brief here. In so holding, we note that the brief, at best, would have been admissible for impeachment purposes. Respondent, however, repeatedly offered the brief as substantive evidence of the facts contained therein.

Ben A. Douglas and *Randall C. Johnson*, for the petitioners.
Val J. Albright and *Marty J. Raisanen*, for the respondent.

KÖRNER, *Judge*: Respondent determined the following deficiencies in petitioners' Federal income taxes:

TYE Dec. 31—	*Deficiency*
1978	$61,684.88
1979	13,491.35
Total	75,176.23

The issues for decision are whether petitioners are entitled to deduct depreciation or amortization expenses, interest expenses, and "annual use fees" in connection with an alleged new retail distributorship business.

Some of the facts have been stipulated and are so found. The stipulation of facts, supplemental stipulation of facts, and exhibits attached thereto are incorporated herein by this reference.

FINDINGS OF FACT

Donald L. Herrick (hereinafter Donald or petitioner) and Marjorie P. Herrick (hereinafter referred to, collectively, as petitioners) were husband and wife and residents of Dallas, Texas, at the time of filing their petition in this Court. Petitioners timely filed their joint Federal income tax returns, Forms 1040, for the taxable years ended December 31, 1978, and December 31, 1979. Petitioners filed an amended return for the year 1979, Form 1040X, on September 25, 1980.

Donald was a financial consultant during 1978 and 1979. As of the date of trial, he was also the chief executive officer or general partner of 22 entities, the majority of which were engaged in investment banking, oil and gas, or real estate.

Petitioner graduated from William Jewell College in Liberty, Missouri, in 1960.[1] From 1960 until August 1963, petitioner was employed by Connecticut General Life Insurance Co. (hereinafter Connecticut General) in Hartford, Connecticut, except for a 6-month period during which he was on active duty with the U.S. Army.

In August 1963, petitioner moved to Kansas City,[2] and was employed as an agent by Connecticut General until 1967. While working for connecticut General, petitioner became acquainted with Lewis F. Coppage (hereinafter Coppage). Coppage was employed as an agent by Connecticut General in Denver. In 1967, petitioner left his employment with Connecticut General and formed his own insurance brokerage firm; he also became involved in real estate activities in 1967, and in oil and gas production in 1968.

In July 1978, petitioner was approached by Coppage, who was at the time the president of Foresee, Ltd., regarding the possibility of becoming a TireSaver distributor. The promoter of the TireSaver was LSI International, Inc. (hereinafter LSI), a

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[1] Petitioner attended law school for a couple of years prior to 1978, but did not graduate.

[2] The record is not clear as to whether petitioner moved to Kansas City, Kansas, or to Kansas City, Missouri.

Nevada corporation. LSI's goal, as stated in the promotional materials, was to establish local distributorships nationwide, with each local distributor having the exclusive right to distribute and sell all products covered by certain U.S. patents in a geographical territory in the United States. During 1978 and 1979, Marco Radomile was the president of LSI.

During 1978, petitioner received promotional materials[3] containing a detailed description of the TireSaver device, market information concerning the TireSaver statistical data, the distributor's program, a marketing study, information concerning the application procedures in order to become a distributor, and an opinion detailing the tax aspects of entering into a TireSaver distribution agreement. According to the aforesaid promotional materials, the TireSaver device consisted of a patented tire pressure monitoring system composed of several components operating together: (1) A pressure sensor mounted on the rim inside the tire; (2) a radio frequency combination transmitter and receiver component located in each of the four wheel wells of the automobile; (3) a dashboard component; and (4) the wiring necessary to connect the wheel well components to the dashboard component.

The promotional materials represented that the TireSaver tire pressure monitoring device was covered by U.S. patent No. 3,873,965, issued on March 25, 1975, that the component located inside the tires was covered by U.S. patent No. 4,023,415, issued on May 17, 1977, and that George E. Garcia of Tiburon, California, was the inventor of the TireSaver device. The marketing study contained copies of the aforesaid patents. The device was allegedly susceptible of being adapted for use in trucks, buses, and other vehicles. According to the prospectus, with some modifications not specified therein, the TireSaver had the capacity to alert the driver of a vehicle to surveillance by police radar.[4]

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[3] One version of the prospectus or promotional materials produced at trial had a number of pages missing, other portions of the said promotional materials were crossed out and marked "outdated information, see new statement of facts." Petitioner could not explain the reason for this. No "new statement of facts" can be identified from the record.

The record contains another copy of the prospectus; the pages of this copy are not marked out, nor are there any pages which appear to be missing. Petitioners also submitted an older version of the promotional materials which does not mention the possibility of adding the radar detection feature to the tire pressure monitoring system.

[4] Neither the marketing study nor the patents contained in the promotional materials explain how the tire pressure monitoring system was to be modified to function as a radar detection device. Furthermore, neither one of the patents makes reference to such capability. See note 3.

The marketing study contained in the prospectus was prepared by J. Walter Thompson Co., Ltd., of London. The marketing study estimated that the potential market for the TireSaver could average at least 1 percent of the total market for passenger cars and 2 percent of all trucks and buses during the 30 to 36 months following the introduction of the device. The study stated that as of 1978, there were 119,690,561 automobiles and 29,429,126 trucks and buses in the United States. The study assumed that the corresponding percentage of the 3.9-percent new vehicles registered each year would also be equipped with the TireSaver. It was also assumed that the combination TireSaver tire pressure monitor and radar detector for use in automobiles would sell for $125 and that the combination unit for use in trucks and buses would retail for at least $235 during 1979.[5] The marketing study assumed, further, that the TireSaver combination tire pressure monitor and radar detector automobile unit could be purchased from a manufacturer by the distributor at $33.25 per unit, and that the truck or bus combination could be purchased for $50.50. The projected gross profit for a TireSaver distributor with an average territory (a territory containing 70,000 vehicles) was as follows:[6]

Year	*Gross profit*
1979	$20,530
1980	23,040
1981	25,510
1982	28,734
1983	32,172

It was not explained in the marketing study, nor anywhere else in the promotional materials, how or what criteria were utilized in arriving at the assumed market penetration percentages, estimated retail prices for the TireSaver and combination TireSaver and radar detector system, or the cost of manufacturing the TireSaver and combination TireSaver and radar detection system.

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[5] The method of determination of the average retail prices of the TireSaver combination is likewise not explained in the marketing study.

[6] The United States was to be divided into about 2,400 individual territories. These amounts are net of assumed normal retail margins, normal wholesale margins, per-unit distribution fees, costs of manufacturing, and normal commissions to manufacturer's representatives.

As of the date that the marketing study was prepared, a model or prototype of the TireSaver or the combination TireSaver and radar detection system had not been tested, manufactured, or produced.[7]

The promotional materials stated that distributorship fees were payable partially in cash and partially by recourse and nonrecourse notes. According to the promotional materials, for every $1 of cash invested, a TireSaver distributor would receive $4 of Federal income tax deductions, for the taxable year 1978.[8] For the taxable year 1979, the income tax writeoff was to be $3 for every $1 of actual cash investment.[9] The said cash investment was to be made by means of a recourse note payable in four installments during 1979.

The tax writeoff was to be achieved by means of nonrecourse promissory notes and a recourse promissory note for 1979, and the election of the accrual method of accounting for the distributorship activity.[10]

The promotional materials contained a tax opinion discussing the availability and legality of deductions in connection with TireSaver distributorship.[11] The opinion suggested that deductions could be obtained pursuant to section 1253,[12] and discussed whether the distributorship activity would constitute an activity engaged in for profit, whether the nonrecourse notes constituted bona fide indebtedness, and the possible application of the at-risk rules in section 465. Finally, the opinion referred to the adoption of a "Tax Shelter Program" by the Internal Revenue Service to identify and examine "abusive tax shelter returns." The opinion forewarned potential distributors that:

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[7] In preparing the marketing study, it was assumed that: (1) The TireSaver technology would be transformed into a workable and feasible product; a manufacturer would be found who would agree to manufacture the devices at the assumed cost to the distributors; and (3) there would be no problems with obtaining the necessary penetration of the market, and no warranty claims. In addition to the above assumption, it was assumed, in making gross profit projections for years after 1979, that: (1) The TireSaver products would not become obsolete; (2) there would be a 7-percent annual inflation with respect to both prices and costs; and (3) there would be a number of replacement parts sold for the TireSaver products.

[8] An example in the promotional materials states that with a cash investment of $11,500 and the signing of a nonrecourse promissory note for $46,000, a distributor in the 50-percent tax bracket would be able to claim a tax deduction in the amount of $46,000, and thus realize $23,000 in tax savings for 1978, as follows: $11,500 × 400% × 50% equals $23,000.

[9] An example in the promotional materials states that for 1979, a cash investment, viz, recourse note, in the amount of $5,750 accompanied by a nonrecourse note for $11,500, would yield $8,625 of the savings for a distributor whose income was taxed at 50-percent rates, as follows: $5,750 × 300% × 50% equals $8,625.

[10] The older version of the promotional materials guaranteed a 4-to-1 writeoff for both 1978 and 1979. The nonrecourse portion of the "amounts to be incurred" was only 3 times the amount of cash for each year, due to the difference in the form of the payments. Initially, the amounts were referred to as "disposition fees," as opposed to annual use fees, the term used in the later version. The distributor would incur the said fee should he dispose of his rights to distribute the TireSaver products. See note 3.

[11] The older version of the prospectus contains an opinion dated July 28, 1978, prepared by Meserve, Mumper & Hughes, a Los Angeles, California, law firm. The other opinion is dated Nov. 2, 1978, and was prepared by Pepper, Hamilton & Scheetz, a Philadelphia, Pennsylvania, law firm. Both opinions contain the language quoted *infra*.

[12] All statutory references are to the Internal Revenue Code of 1954 as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

> In this case, as in any leveraged tax shelter,* * * acquisition of a distributorship will be regarded by the [Internal Revenue] Service as an "abusive" tax shelter and, therefore, the likelihood that the purchaser's tax return will be subject to audit may be increased.

The promotional materials stated that:

> In the event that a TireSaver Distributor adopts for tax purposes the position outlined in the LSI tax opinion and in the event the Distributor's deductions are challenged by the Internal Revenue Service, LSI will defend its tax position and that of its Distributors through each step of the Administrative process and, if necessary, before the United States Tax Court.

The older version of the promotional materials reviewed by petitioner[13] contained the following statement concerning other inventions and patents by George E. Garcia, the named inventor of the TireSaver device:

> Patents in 1960 pertaining to hydraulics used in excavation; formed own company, "Hydraulic Equipment and Shovel Company" ("Hesco"), in Houston, Texas. Sold company Drott Manufacturing in Wausau, Wisconsin. Later Drott merged with J. I. Case, Co., which, in turn, is now owned by Tenneco. *Sales revenues generated by this patent have been in excess of $400,000,000 per year.*[14]

At the time when petitioner obtained the promotional materials, the TireSaver was not yet being produced; the prospectus so stated. The prospectus represented, however, that LSI had firm offers to manufacture the TireSaver from major industrial companies, and that no contract was to be entered into until all offers were adequately reviewed.[15] Potential distributors were required to be aware of the fact that no enforceable contracts had been executed and that the proposed wholesale and retail prices in the promotional materials and in the distributorship agreement were estimates based upon negotiations with unnamed manufacturers.

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[13] See note 3.

[14] Robert D. Goddard, Director of Patents, Trademarks, and Licensing at J.I. Case Co. conducted a search of J.I. Case records pertaining to HESCO, Drott Manufacturing, George E. Garcia, and Garcia, Ltd., and was unable to locate any records of any patents covering hydraulic excavation devices invented by George E. Garcia.

LSI advised potential distributors to consider the fact that LSI was a newly formed company whose sole purpose was to acquire and exploit the distribution rights for TireSaver, and that although the management of LSI had "significant general business experience" (not detailed in the promotional materials), it had never marketed an automotive product.

An individual, partnership, corporation, or other entity desiring to become a TireSaver distributor had to fill out an application.

The final prospectus distributed by LSI contained the following questions and answers, among others:[16]

> What are the tax aspects of becoming a TireSaver distributor? The tax aspects of becoming a TireSaver distributor may be very advantageous. As more fully stated in LSI's legal opinions non-recourse notes paid to LSI in 1978 and 1979 will be fully deductible, allowing a TireSaver distributor a tax deduction of 400% of his 1978 cash investment and 300% of his 1979 cash investment.
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> Will I be audited if I make this investment? If you are the type of high inc[o]me taxpayer suitable for a tax shelter investment, you are unusual if you have not been audited already. The IRS does seek to audit persons who pay relatively little tax on high income so that any method of achieving this goal, including tax shelter transactions, can lead to an audit.
>
> What happens if the IRS disagrees with counsel's tax opinion and seeks to disallow my deductions? If the IRS does this, the IRS may be reversed and in any event it can take a number of years until the appeals procedure is exhausted. During this time, you may use your tax savings profitably even if the IRS is eventually upheld. You have, at the very least, achieved a shifting of your tax burden from an earlier year to a later year. Your taxes may therefore be paid with the earnings from your tax savings or with inflated dollars that cost you far less.

Petitioner's copy of the prospectus had a number of pages missing, and other portions were crossed out and marked "outdated information, see new statement of facts." The missing pages contained the above-mentioned questions. No new statement of facts was contained in petitioner's copy of the prospectus.

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[15] None of the promotional materials which were made available to petitioner prior to his investment named any of the "major industrial companies" referred to in this context.

[16] See note 3.

In making his decision whether to invest in the TireSaver distributorship, petitioner did not consult an engineer or patent attorney with regard to the feasibility and viability of the TireSaver and the combination TireSaver and radar detector device. Petitioner did not make inquiries concerning: (1) The reputation and bona fides of Marco Radomile; (2) George E. Garcia, the named inventor of the TireSaver device and his claims that he was the inventor of some other, very profitable, patents; (3) the names of the "major industrial companies" from which LSI represented that it had firm offers to manufacture the TireSaver; (4) the nature and extent of the "significant general business experience" allegedly possessed by LSI's management; or (5) LSI's financial situation. Petitioner requested his attorney, Edward M. Dolson, to review the tax opinion contained in the promotional materials and to advise him whether it accurately stated the tax issues, and as to the quality of the firm which had prepared the opinion. Petitioner's attorney furnished him with copies of the résumé of Pepper, Hamilton & Sheets, as it appeared in the Martindale-Hubbell Law Directory for the year 1978. He also stated his belief that the aforesaid opinion was reliable.

In late December 1978,[17] petitioner executed the required paperwork in order to become a TireSaver distributor. Petitioner's territory was to be Johnson County, Kansas, which includes Mission Hills, Shawnee, Mission, Merriam, Overland Park, Prairie Village, Leawood, Olathe, Lenexa, and Kansas City. Kansas City, Kansas, is approximately 480 miles from Dallas, Texas, where petitioners resided.

The documents executed by petitioner included: (1) An application for TireSaver distributorship; (2) a "Distributor warranty statement to be fully completed by applicant for distributorship" (hereinafter warranty statement); (3) a "Distributor Agreement between LSI International, Inc. and Donald L. Herrick" (hereinafter distributor agreement); (4) a "Non-recourse promissory note - year 1 first note" in the amount of $147,339.97; (5) a "Non-recourse promissory note -

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[17] Schedule C of petitioners' 1978 Federal income tax return reflects that the TireSaver distributorship was acquired on Dec. 26, 1978.

year 2 second note" in the amount of $36,834.99; (6) a "Recourse promissory note" in the amount of $17,616.74; (7) a "Security agreement"; and (8) a check payable to LSI in the amount of $36,834.99,[18] dated December 26, 1978.

The warranty statement contained a statement that petitioner acknowledged that no manufacturer had been engaged to produce the products at the price structure described in the marketing study, and that there was no guarantee that a manufacturer would be found, or even if a manufacturer was found that the products would be produced at the price structure described in the marketing study. The warranty statement also stated that petitioner was aware that the officers, directors, and shareholders of LSI would receive substantial compensation in connection with the sales of distributorships and that no amounts collected from persons such as petitioner were warranted to be used for marketing, manufacturing, or development costs relative to the TireSaver products. The warranty statement contained a statement that the applicant had independently evaluated the merits of acquiring a distributorship and was not relying on the information contained in the marketing study. The warranty statement required petitioner to certify that: (1) He anticipated "(not taking into account any income tax deductions to be realized as a distributor) taxable income for the year 1978 equal to at least twice the dollar value of the fee payable in such year upon the disposition of the rights granted by the agreement"[19] and, (2) his net worth, exclusive of personal residence and automobile, was at least $250,000. Petitioner stated, in signing the aforesaid statement, that he understood that he had the opportunity to obtain additional information—necessary to verify the accuracy of the information contained in the marketing study, the promotional brochures, and the agreement—describing the products, the marketing network, and the duties and obligations of the distributors. Petitioner elected not to avail himself of this opportunity. The warranty statement was accepted, on December 30, 1978, by Marco Radomile on behalf of LSI.

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[18] $1,601.52 of the said amount constituted payment of promotional funds to be deposited to a special account and remitted to petitioner for any and all purposes relevant to the promotion and sale of the products upon receipt of petitioners' proposal by LSI, according to the terms of the distributor agreement.

[19] See note 10 *supra*.

The distributor agreement stated that it was effective as of November 1, 1978. Under the aforesaid agreement, petitioner was granted the exclusive right to sell, promote, and otherwise distribute TireSaver products—the TireSaver tire pressure monitoring system and the combination TireSaver and radar detection system—in Johnson County, Kansas. The rights granted were limited by the distributor agreement to the retro market.[20] The term of the distributor agreement was to be for 20 years, with the possibility of a 10-year extension, provided the parties thereto mutually agreed. In consideration of the distribution rights to the TireSaver tire pressure monitoring system, petitioner was to pay LSI an acquisition fee by check. In addition to the acquisition fee, the distributor was to pay unit royalties for every TireSaver tire pressure monitoring system or combination tire pressure monitoring system and radar detection device sold.

Should petitioner wish to license the exclusive right to sell the *combination* TireSaver and radar detection system, an additional annual use fee was to be paid on the first day of the year to which it applied. For years 1, and 3 to 7, the annual use fee was to be paid by means of a nonrecourse, interest-bearing (at 10-percent annual rate), 15-year term note. In year 2, two-thirds of the annual use fee was to be paid by nonrecourse note. Interest and principal on the aforesaid notes was to be payable from 40 percent of the gross profits generated by the TireSaver and the combination TireSaver and radar detection system.

In addition to any other royalties, acquisition, or annual use fees, petitioner was to pay LSI a royalty equal to 8 percent of the gross sale income from the sale of the tire pressure monitoring device and 4 percent of the gross sale income from the sale of any other products licensed for sale by the distributor, within 30 days of the receipt of the sales proceeds. Petitioner was further required by the agreement to pay LSI promotional funds which were to be deposited to a special, separate account, and remitted to petitioner for any purposes relevant to the promotion and sale of products covered by the agreement upon receipt of a signed proposal for the use of such funds by LSI. The distributor agreement stated that:

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[20] Defined as sales to purchasers who did not intend to install the devices as original equipment on newly manufactured vehicles, or replacement use of the devices. Also excluded were the right to sell to the United States or any of its agencies, to any foreign government, and the export business.

> neither the Company [LSI] nor the manufacturer shall be under any obligation to the Distributor to manufacture, sell, or supply or to continue to manufacture, sell, or supply any of the Products, and no warranty of any nature as to any of the Products shall run from the Company [LSI] or the Manufacturer to the Distributor, at any specified price or prices except as may be agreed between the parties hereto from time to time.

The distributor agreement signed by petitioner further stated:

> The Distributor hereby covenants and agrees to indemnify the Company [LSI] and the Manufacturer and hold them harmless for any and all actions, causes of action, claims, costs, expenses, attorneys' fees, suits, judgments, fines, administrative or regulatory agency action, settlements or any other liabilities, losses or damages, that the Company or the Manufacturer may suffer or incur, arising out of or in any way related to the formation and organization of the Distributor, the acquisition of the distributorship rights granted hereby, the formation and organization of any assignee or transferee of any of the rights granted hereby, the transfer of any of the rights granted hereby to any third party for the purpose of marketing the Products on behalf of the Distributor and the compliance of the foregoing with appropriate federal or state securities, franchise, or other applicable law.
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> * * *

The aforesaid agreement also stated that if a product were no longer available, the agreement was cancelable or alterable at the sole discretion of LSI. The distributor agreement was signed by Marco Radomile, on behalf of LSI, and by petitioner.

Petitioner signed a "Non-recourse promissory note - year 1 first note," pre-dated November 1, 1978. The said note provided that petitioner promised to pay to the order of LSI the sum of $147,339.97, together with annual interest thereon at the rate of 10 percent from November 1, 1978, to November 1, 1994. Petitioner was not personally liable for payment of this note. The note represented payment of the annual use fee for 1978. Petitioner also executed an undated nonrecourse 15-year promissory note for $36,834.99, representing two-thirds of the annual use fee for 1979. Petitioner assumed no personal liability for the payment of this note. The note was secured by a security interest in petitioner's rights under the distributor agreement. The aforesaid nonrecourse notes incorporated the distributor agreement by reference, which required that prior to the due date of the said notes, interest and principal on the notes would be payable currently from 40 percent of the gross profits, viz, total receipts less amounts paid LSI (except for "annual use fee"), from the sales of the TireSaver, the combination TireSaver and radar system, and components thereof. In addition, petitioner signed a recourse promissory note for $17,616.74, representing one-third of the annual use fee for 1979, pre-dated December 15, 1978.[21]

Sometime prior to the due date of petitioners' Federal income tax return for the taxable year 1978, Donald received a letter from LSI containing a model Schedule C, Profit or Loss from Business or Profession, demonstrating how to claim deductions in connection with the distributorship activity. The aforesaid model Schedule C indicated that the accrual method of accounting had been elected in connection with the TireSaver activity, that a method of valuing inventory had not been selected or was inapplicable, and that the distributorship was acquired on December 29, 1978.

Petitioners received a letter from LSI, dated November 15, 1979, informing him that there were serious problems with the transceiver component of the TireSaver. The letter also stated that:

> Before LSI will be in a position to deliver commercial quantities of TireSaver, LSI must, among other things, further solve problems under the arrangement with its licensor relating to the TireSaver patents. In addition, LSI's cash position is such that it believes that its resources are best utilized developing the TireSaver System and consequently does not presently expect to be able to pursue the cruise control, radar device or other projects of its subsidiary A.E.C.
>
> Pending satisfactory answers to the above questions, *LSI is declining to accept payments for [sic] distributors, whether payments of prior recourse or non-recourse notes, or delivery of additional notes and payments of annual use fees.* [Emphasis added.]

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[21] The recourse note was payable in installments as follows:

Due date	*Installment*
Mar. 15, 1979	$4,844.60
June 15, 1979	4,734.50
Sept. 15, 1979	4,624.39
Dec. 15, 1979	4,514.29

The record contains no evidence of payment of the marketing and promotional expense in the amount of $800.76, which was supposed to be paid for 1979.

Petitioner received a letter, dated January 25, 1980, stating that LSI was accepting offers for radar detector devices at a cost to the distributor of $129 per unit. On or about February 12, 1980, petitioner ordered a radar detection device from LSI.[22]

LSI sent a letter to petitioner, dated February 15, 1980, which stated as follows, with regard to the TireSaver tire pressure monitoring system:

> There is no way to tell how long road testing will take. Once it is begun, *if the road testing is successful and a commercially viable product can be produced, LSI will at that time consider the acceptance of note payments.* [Emphasis added.]

Petitioner received a letter, dated November 20, 1980, stating that LSI was negotiating with Tiretronics Japan Co., Ltd., for the manufacture of the TireSaver and the combination TireSaver and radar detector device. The estimated cost to the distributors was to be between $60 and $80 for the TireSaver and between $185 and $205 for the TireSaver and radar detector system combination. On or about December 7, 1980, petitioner ordered one TireSaver tire pressure monitoring device and one combination TireSaver and radar detector device from LSI.[23]

Petitioner subsequently received a letter, dated March 25, 1981, from LSI stating that pre-production TireSaver units were to be available as of late April 1981, and that said units would cost the distributor $275 per unit. The TireSaver compatible radar detection device was to cost an additional $129 per unit. Petitioner sent a letter to LSI, dated April 8, 1981, ordering the TireSaver and the radar detection device and authorizing LSI to deduct $404 from the $1,601.52 being held in escrow by it as promotional funds.

A letter from LSI, dated May 4, 1981, notified petitioner that LSI had executed an exclusive distributorship agreement with Tiretronics Japan Co., Ltd., and that pre-production units of the TireSaver and the combination TireSaver and radar detection device would be available by June 1981 at an approximate cost of $100 for the TireSaver and an additional

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[22] The record does not contain canceled checks, money orders, or any evidence reflecting payment for the TireSaver products.

[23] See note 22.

$135 for the units with radar. The letter also stated that payment on the recourse note for the second year's (1979) use fee was being requested, and gave the distributors the option to apply the amounts held by LSI in escrow, as promotional funds, toward the amount owing on the recourse notes. Petitioner executed a statement reflecting that the amount due on the recourse note was $17,616.74, and that he consented to application of the $1,601.52 of promotional funds against the amount due on the recourse note.

Petitioner was notified, by letter dated May 8, 1981, of additional problems in connection with the TireSaver products, and that there would be further delays in manufacturing any radar detection device.

The TireSaver design was not viable, and was unmarketable and essentially worthless without substantial modification.[24] The rights to distribute the TireSaver and the combination TireSaver and radar detector device thus were also worthless.

As of the date of trial, petitioner had made no payments of principal or interest toward the notes, recourse or nonrecourse, nor had he sold any TireSaver devices. LSI did not take any legal action, nor did it make any demand of payment in connection with the recourse or nonrecourse notes. Petitioner never received a functional, workable, marketable product. Petitioner did not maintain a separate bank account with respect to the TireSaver distributorship.

Petitioners claimed a $150,863.77 loss from the distributorship activity on Schedule C, Profit or (Loss) From Business or

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[24] The record contains substantial evidence submitted by respondent, through an instrumentation engineer and an electrical engineer whom we consider qualified, concerning the TireSaver technology and patents.

The design of the tire pressure monitor had many serious defects including: (1) Problems with locating and aiming the radio frequency transmitter and receiver so that a Doppler signal—"a change in the frequency with which waves (as sound, light, or radio waves) from a given source reach an observer when the source and the observer are in rapid motion with respect to each other so that the frequency increases or decreases according to the speed at which the distance is decreasing or increasing" (Webster's Ninth New Collegiate Dictionary (1984))— would not be reflected off the wheel rims, the steel belts in radial tires, or snow chains; (2) problems with locating and aiming the radio frequency transmitter and receiver to avoid a Doppler signal being reflected off the aforesaid items as a result of the movement of the front tires of the automobile through turning or bumps; (3) problems with locating and aiming the radio frequency transmitter and receiver in such a manner that there would not be a Doppler signal reflected as a result of load factors in the automobile; (4) problems with the reference chamber inside the tire caused by bumps and heat; (5) problems with the inlet valve on the reference chamber as a result of leakage caused by weak pressure differential, vibration, pollution of its environment by moisture, dust particles, and other contaminates; and (6) problems with the outlet valve.

Profession, of their 1978 income tax return.[25] Petitioners had taxable income, not taking into account the claimed $150,863.77 loss from the TireSaver distributorship, of $178,287.91,[26] in 1978. Petitioners elected the accrual method of accounting with respect to the TireSaver distributorship activity;[27] petitioners also noted that a method of valuing inventory had not been selected or was inapplicable as had been previously indicated to them by LSI. On Schedule C of their income tax return for the taxable year ended December 31, 1979, petitioners claimed a loss from the TireSaver distributorship in the amount of $33,316.[28] Petitioners had taxable income, not taking into account the claimed $33,316 loss, in the amount of $86,952.42, in 1979.

Respondent disallowed all the losses claimed by petitioners on their Federal income tax return for taxable years 1978 and 1979 on a variety of grounds (see discussion *infra*).

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[25] Computed as follows:

Item	*Amount*
Total income	0
Depreciation	$3,523.80
Distributor use fee	147,339.97
	150,863.77

The depreciation deduction apparently represents one-tenth of the "acquisition fee" of $35,233.47. However, one-tenth of $35,233.47 is $3,523.35 and not $3,523.80, as claimed by petitioners.

The $147,339.97 represents the annual use fee for 1978, covered by a nonrecourse note.

[26] Including a $44,529.96 net capital gain resulting from transactions which were completed prior to the end of February 1978.

[27] Petitioners elected the cash method of accounting with respect to petitioner's financial consulting activity.

[28] Computed as follows:

Item	*Amount*
Total income	0
Depreciation	($3,524)
Interest on business indebtedness	(16,496)
Distributor use fee	(13,296)
Claimed loss	(33,316)

Petitioners deducted $3,524 as depreciation, however, one-tenth of $35,233.47 is $3,523.35 and not $3,524, as claimed by petitioners. The interest deduction in the amount of $16,496 represents interest on the $147,339.97 nonrecourse note and the $17,616.74 recourse note. The computation is as follows: $147,339.97 plus $17,616.74 equals $164,956.71, multiplied by 10 percent is $16,495.67; rounded to the nearest dollar.

It is unclear how the deduction in the amount of $13,296 for the distributor use fee was computed, although it may have been the result of petitioners' return preparer's interpretation of the application of the at-risk provisions of sec. 465.

OPINION

The ultimate issue to be decided is whether petitioners are entitled to deduct claimed losses resulting from Donald's investment in a TireSaver distributorship.[29]

Respondent advances a wide array of arguments in support of his disallowance of the deductions claimed by petitioners. Respondent's primary contention is that the TireSaver distributorship losses were incurred in an activity not engaged in for profit, and therefore, petitioners are not entitled to deduct depreciation or amortization expenses in connection with the acquisition fee for 1978, annual use fees for 1978 and 1979, and interest expense for 1979, under sections 162 and 1253(d). Alternative arguments advanced by respondent include the following: (1) The nonrecourse notes delivered as payment of the annual use fee for 1978, in the amount of $147,339.97, and partial payment of the annual use fee for 1979, in the amount of $36,834.99, were contingent, speculative, and should not be recognized for Federal income tax purposes; (2) the above-mentioned nonrecourse notes should not be recognized for income tax purposes as the fair market value of the property securing the notes does not even approximate their face amount; (3) the aforementioned nonrecourse notes do not constitute bona fide liabilities which will permit the accrual of interest deductions; (4) the recourse note in the amount of $17,616.74, given by petitioner as partial payment of the annual use fee for 1979, does not support the accrual of a deduction for 1979, since LSI (the payee) made payment of the note conditional upon successful development of a product; (5) no interest was properly accruable for 1979 in connection with the above-mentioned recourse note as interest was also conditional on the development of a viable product; and (6) payments under section 1253(d) must run the gauntlet of section 162 in order to be deductible.

Section 183(a)[30] provides that if an individual's activity constitutes an activity "not engaged in for profit," the deductions arising out of such activity shall not be allowed except as provided in section 183(b). An "activity not engaged in for profit" is defined in section 183(c) as "any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212." If the activity is not engaged in for profit, section 183(b) separates the claimed deductions into two groups. Section 183(b)(1) allows only those deductions which are not dependent upon a profit motive, e.g., interest and taxes. Section 183(b)(2) allows the balance of the deductions which would otherwise be permitted only if the activity was engaged in for profit, but only to the extent that the gross income derived from the activity exceeds the deductions allowed under section 183(b)(1).

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[29] See notes 25 & 28 *supra*.

[30] Sec. 183 provided, in pertinent part, as follows, during the years in issue:

SEC. 183. ACTIVITIES NOT ENGAGED IN FOR PROFIT.

(a) GENERAL RULE.—In the case of an activity engaged in by an individual or an electing small business corporation (as defined in section 1371(b)), if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this chapter except as provided in this section.

Section 1253(d)(1)[31] provides that amounts paid or incurred during the taxable year on account of a transfer of a franchise which are contingent on the use of the transferred franchise shall be allowed as a deduction under section 162(a).

Section 162(a) allows as a deduction all the necessary and ordinary expenses paid or incurred during the taxable year in carrying on any trade or business. In order to constitute the carrying on of a trade or business under section 162, an activity must "be entered into, in good faith, with the dominant hope and intent of realizing a profit therefrom." *Hirsch v. Commissioner*, 315 F.2d 731 (9th Cir. 1963), affg. a Memorandum Opinion of this Court; *Dreicer v. Commissioner*, 78 T.C. 642 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983). See also *Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984), affg. 78 T.C. 471 (1982); *Hager v. Commissioner*, 76 T.C. 759 (1981), and cases cited therein. "Profit," in this context, means economic profit, independent of tax savings. *Surloff v. Commissioner*, 81 T.C. 210 (1983).

(b) Deductions Allowable.—In the case of an activity not engaged in for profit to which subsection (a) applies, there shall be allowed—

(1) the deductions which would be allowable under this chapter for the taxable year without regard to whether or not such activity is engaged in for profit, and

(2) a deduction equal to the amount of the deductions which would be allowable under this chapter for the taxable year only if such activity were engaged in for profit, but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).

(c) Activity Not Engaged in for Profit Defined.—For purposes of this section, the term "activity not engaged in for profit" means any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

[31] Sec. 1253(d)(1) provided as follows during the years in issue:

SEC. 1253(d). Treatment of Payments by Transferee.—

(1) Contingent payments.—Amounts paid or incurred during the taxable year on account of a transfer, sale, or other disposition of a franchise, trademark, or trade name which are contingent on the productivity, use, or disposition of the franchise, trademark, or trade name transferred shall be allowed as a deduction under section 162(a) (relating to trade or business expenses).

The issue of whether a taxpayer engages in an activity with the requisite intention of making a profit is one of fact to be resolved on the basis of all the surrounding facts and circumstances. Sec. 1.183-2(b), Income Tax Regs.; *Engdahl v. Commissioner*, 72 T.C. 659 (1979); *Allen v. Commissioner*, 72 T.C. 28 (1979). In determining whether an activity is engaged in for profit, the following factors are to be considered: (1) The manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profit, if any, which is earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. Sec. 1.183-2(b), Income Tax Regs.; *Boyer v. Commissioner*, 69 T.C. 521 (1977); *Benz v. Commissioner*, 63 T.C. 375 (1974). It is not intended, however, that only the aforesaid factors be taken into account in making the determination. Sec. 1.183-2(b), Income Tax Regs.

Respondent's determination is presumptively correct. *Welch v. Helvering*, 290 U.S. 111 (1933). The burden of proving the requisite profit objective is on the taxpayer. Rule 142(a).

From a close examination of the record as a whole we are satisfied and so find that the TireSaver activity was not an activity engaged in for profit. Rather, we are convinced that petitioner engaged in the TireSaver activity primarily, if not exclusively, in order to obtain the tax advantages offered in the prospectus or promotional materials.

Prior to becoming a financial consultant, petitioner had been an insurance salesman and broker; petitioner had also invested in oil and gas and real estate ventures. Other than presumably owning automobiles, petitioner had no knowledge or experience in connection with the design, manufacture, marketing, or sale of automotive parts. By his own admission, petitioner lacked any mechanical abilities. We do not think, and petitioners do not argue to the contrary, that petitioner's experience in selling insurance or in investing in real estate or oil and gas ventures translated into expertise in the automotive parts marketing business. In evaluating the opportunity of investing in a TireSaver distributorship, however, petitioner did not seek to inform his conceded ignorance on these matters. No inquiries were made by petitioner regarding the bona fides and qualifications of LSI's management, George E. Garcia, the named inventor of the TireSaver device, and his claims that he was the inventor of some other very profitable patents,[32] the names of the "major industrial companies" from which LSI represented that it had firm offers to manufacture the TireSaver, or the feasibility and viability of the TireSaver device. Petitioner did not give importance to the fact that no prototypes or pre-production models of the TireSaver were available in late 1978 when petitioner signed the required paper work to become a TireSaver distributor, even though claims were being made by LSI that a functional, viable product would be available to be marketed in early 1979 and, presumably, the success of the distributorship activity was dependent upon the availability of such product. Petitioner did not inquire as to the reason why the prospectus had crossed out portions and missing pages. Petitioner did not take into account the operating expenses of the distributorship's office and activities—rent, supplies, stenographic and clerical assistance, salesmen and representatives' salaries and commissions, telephone costs, telegrams, agency licenses and taxes, automobile and other insurance, and the like—not allowed for in the marketing study.[33] Failure to make such elementary inquiries and to obtain expert advice in a transaction of the magnitude of this one is not consistent with ordinary sound business practice, and may be regarded as evidence that petitioners lacked a profit motive. See *Flowers v. Commissioner*, 80 T.C. 914 (1983); *Surloff v. Commissioner*, 81 T.C. 210 (1983).

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[32] See note 14.

[33] Pursuant to sec. 4.10 of the distributor agreement, the distributor was solely responsible for the payment of these expenses.

Concededly, a taxpayer's expectation of profit need not be reasonable. *Dreicer v. Commissioner, supra.* We are not required, however, to ignore petitioner's selectivity in evaluating the transaction herein. The facts and circumstances must indicate that the taxpayer had the requisite profit objective. *Dreicer v. Commissioner, supra.* Petitioner was provided with the opportunity of obtaining additional information necessary to verify the accuracy of the information contained in the marketing study, the promotional brochures, and the agreement, describing the products, the marketing network, and the duties and obligations of the distributors, as stated in the warranty statement; he elected not to avail himself of it. Petitioner did seek, however, his attorney's opinion as to the correctness of the tax opinion contained in the promotional materials, and his opinion of the firm rendering the tax opinion. Petitioner's attorney supplied him with a copy of the said firm's résumé contained in the Martindale-Hubbell Law Directory. Although petitioner testified that prior to his decision to invest in the TireSaver distributorship, he met with other purchasers of distributorships, with territories adjacent to the territories that he was considering, to discuss marketing strategies, his failure to present their testimony to corroborate such claims permits us to draw the inference that their testimony would not be supportive of petitioner's contention. *Wichita Terminal Elevator Co. v. Commissioner*, 162 F.2d 513 (10th Cir. 1947.[34]

Petitioner did not open a bank account for the distributorship activity, nor did he make arrangements to find a warehouse for the TireSaver products, nor hire any employees.[35] Petitioners argue that Donald was ready to perform all the aforesaid activities as soon as he had a product to sell. Greater weight should be given, however, to objective facts than to mere statements of intent. *Dreicer v. Commissioner, supra.* Petitioner would have us find that he honestly believed, in making the investment in issue herein, that a feasible, marketable TireSaver product was to be delivered to him in early 1979, yet he took no steps to insure that he would have a place to store the products, the rights to distribute which were to cost him at least $239,427.45, according to the paperwork executed by him.[36]

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[34] See also *Jameson v. Commissioner*, T.C. Memo. 1985-262.

[35] Petitioners resided 480 miles from Johnson County, Kansas, his territory. In addition, petitioner was a financial consultant and chief executive officer or general partner of 22 entities.

The record also indicates a history of substantial deductions attributable to the yearend investment in the TireSaver distributorship,[37] which were offset against petitioner's substantial income from other sources, but no gross receipts, thus enabling petitioner to claim $4 in deductions for every $1 of cash investment in 1978.[38]

Petitioners have failed to carry their burden of proving a primary profit motive in engaging in the TireSaver activity. They are not entitled to business deductions under sections 162 and 1253(d)(1) with respect to the annual use fees for the years 1978 and 1979.

We now turn to section 183 to determine the amount, if any, of the deductions which are allowable under section 183(b)(1). Specifically, this issue is limited to the $16,496 of interest deducted by petitioners for 1979.[39]

Section 163(a) allows a deduction for "all interest paid or accrued within the taxable year on indebtedness." Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. Sec. 1.461-1(a)(2), Income Tax Regs.; *United States v. Anderson*, 269 U.S. 422 (1926). The proper accrual of the interest expense is in turn dependent upon the proper accrual and bona fides of the underlying indebtedness.

The annual use fee was payable, pursuant to section 3.03 of the distributor agreement, for any year during the term of the agreement, in consideration for the exclusive right to sell the combination TireSaver and radar detection system. Given LSI's failure to produce a viable product, the use of the distributorship for the sale of the dual purpose system was impracticable, and petitioner's election to distribute the dual purpose system—predicated upon the assumption that the patented system and the dual purpose system were operational, that a contract for their manufacture was to be agreed upon soon, and that the systems were to be available so that it would be possible to solicit orders no later than early 1979—was futile; thus no obligation to pay the annual use fees arose.

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[36] The addition of the acquisition fee ($35,233.47), marketing and promotional expense for 1978 ($1,601.52), nonrecourse note for 1978 use fee ($147,339.97), marketing and promotional expense for 1979 ($800.76), nonrecourse note portion of use fee for 1979 ($36,834.99), and recourse portion of annual use fee for 1979 ($17,616.74) equals $239,427.45.

[37] See note 17.

[38] The amount of the nonrecourse note, representing payment of the annual use fee for 1978 is four times the cash investment for 1978, as follows: (acquisition fee $35,233) plus marketing and promotional expense for 1978 ($1,601.52), multiplied by 400 percent equals $147,339.96. Petitioners' goal of achieving 300 percent worth of deductions for every dollar invested in 1979 was, to a certain extent, frustrated by petitioners' return preparer's interpretation of the at-risk provisions of sec. 465. We note that no payments were made on the recourse note during 1979 and 1980. See note 42.

[39] Presumably, the $16,496 deduction represents interest on the $147,339.97 nonrecourse and the $17,616.74 recourse notes, as follows: $147,339.97 plus $17,616.74 equals $164,956.71, multiplied by 10-percent interest rate equals $16,495.67; rounded to the nearest number. No interest deduction was claimed with respect to the $36,834.99 nonrecourse note.

With regard to the nonrecourse note,[40] the distributor agreement provided that the interest and principal on such note was to be payable only from 40 percent of the gross profits—defined as the selling price of the products sold by the distributor, reduced by the unit royalties—generated by the TireSaver and the dual purpose system. No gross profits were generated as no TireSaver products were ever manufactured.[41]

In addition, petitioner received a letter from LSI, dated November 15, 1979, stating that LSI was declining to accept payments of the annual use fees, represented *by the recourse and nonrecourse notes*, pending satisfactory resolution of the problems inherent to the development of the TireSaver system.[42] It was petitioner's intention that the notes would not be paid until a viable product was furnished by LSI. Petitioner testified as follows:

> I did not even pay the first quarter [on the recourse note], because I felt that they should have had a product there by that time and Marco [Radomile] said he was going to sue me for not paying the note. And I said go ahead.[43] We will—because *when you get me a product* I will pay the note, but in the

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[40] Apparently, petitioners did not take any deductions with respect to the nonrecourse note, in the amount of $36,834.99, given as partial payment of the annual use fee for 1979.

[41] Petitioner testified that he had received a radar detection device from LSI which lacked tire pressure monitoring capability. According to petitioner, the wholesale price for the device was in excess of the retail price for competitive devices and, thus the device was worthless from a retail marketing standpoint. Petitioner testified further, that he received a tire pressure monitoring device in 1980 which did not work. Petitioner's testimony that he received a radar device in 1979 and a tire pressure monitoring device in 1980, is inconsistent with the correspondence from LSI presented by petitioners.

[42] As of Nov. 15, 1979, three of the four payments on the $17,616.74 recourse note were due, and unpaid.

[43] There is no evidence that LSI instituted any legal action or made any demands for payment with respect to the recourse or nonrecourse notes.

> meantime, *I am not giving you another cent until I get a product.*[44] [Emphasis added.]

It is well established that in order for a liability to be accruable, it must be binding and enforceable; must not be contingent on a future event; the amount of the liability must be certain; and there must be a reasonable belief on the part of the debtor that the liability will be paid. *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976), affd. 601 F.2d 734 (5th Cir. 1979); *United Control Corp. v. Commissioner*, 38 T.C. 957 (1962). We are satisfied that the notes herein at issue do not satisfy the aforesaid requirements and that the annual use fees and the interest on the notes given as "payment" are not deductible for the years in issue, as they were improperly accrued.

Furthermore, petitioners have failed to prove that the purchase price and the principal amount of the nonrecourse note did not unreasonably exceed the value of the distributorship. It is well settled law that in order for an interest deduction to be allowable, the indebtedness must be genuine. See *Hager v. Commissioner*, 76 T.C. 759 (1981). If the purchase price and the principal amount of the notes unreasonably exceed the value of the property to be purchased, then no genuine indebtedness exists.[45] *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976), affg. 64 T.C. 752 (1975); *Hager v. Commissioner*, *supra*.

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[44] Petitioners introduced in evidence a letter from LSI, dated May 4, 1981, stating that LSI had entered into an "exclusive distributorship agreement" with a Japanese company, and that the next payment on the recourse note for the second year's (1979) use fee was now being requested. The letter also stated that those distributors with amounts in escrow for promotional purposes could elect to have LSI apply the balance in that account towards payment on the note. Petitioner executed an undated statement reflecting that the amount due on the recourse note was $17,616.74, the principal amount of the note, and that he consented to the application of the promotional funds in the amount of $1,601.52 held in escrow by LSI, against the note. We note, however, that the record contains another letter from petitioner to Marco Radomile, as president of LSI, dated Apr. 8, 1981, in which petitioner authorized the transfer to $404 out of the promotional funds account to pay for pre-production TireSaver and combination TireSaver and radar detection system units.

[45] In *Brannen v. Commissioner*, 78 T.C. 471 (1982), affd. 722 F.2d 695 (11th Cir. 1984), this Court stated that the test was whether the stated purchase price unreasonably exceeded the value of the property, whereas in *Hager v. Commissioner*, 76 T.C. 759 (1981), this Court stated that the test was whether the principal amount of the nonrecourse indebtedness unreasonably exceeded the value of the property. We need not decide that issue here because both the purchase price and the principal amount of the note far exceed the value of the TireSaver distributorship and other attendant rights acquired by petitioner.

Petitioners contend, however, that *Tufts v. Commissioner,* 461 U.S. 300 (1983), requires that, irrespective of market value of the property, respondent is required to recognize the principal amount of the nonrecourse obligation and the interest payable thereon as a deductible expense. Our analysis and understanding of *Tufts v. Commissioner, supra,* is to the contrary.

Tufts v. Commissioner, supra, dealt with an issue which was suggested, but not resolved, by *Crane v. Commissioner,* 331 U.S. 1 (1947).[46] *Crane v. Commissioner, supra,* held that a taxpayer who sold property encumbered by a nonrecourse mortgage, the principal amount of which was less than the value of the property, must include the unpaid balance of the mortgage in the computation of the amount the taxpayer realized on the sale. *Tufts* held that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the fair market value of the property at the time of the sale.

In *Tufts v. Commissioner, supra,* a partnership financed the construction of an apartment complex by a nonrecourse mortgage in the amount of $1,851,500. The mortgage was extended by an institutional lender, and it was Government-insured. From all that appears, the principal amount of the mortgage did not exceed the fair market value of the complex when it was completed. For 2 years after completion, all partners claimed, as income tax deductions, their allocable shares of losses and depreciation computed on a basis which included the principal amount of the nonrecourse mortgage. Shortly after completion of the complex, rental income decreased below expectations as a result of adverse economic conditions in the area, and the mortgage became in default. Each partner then sold his interest in the property to a third party for a nominal amount, plus assumption by the third party of the nonrecourse mortgage. On the date of transfer of ownership, the partnership's adjusted basis in the property was $1,455,740, and the property's fair market value did not exceed $1,400,000. Each partner claimed as a tax loss his share of the difference between the selling price and the fair market value of the property ($55,740). The Commissioner, however, took the position that each partner had realized a gain because the partnership had realized the full amount of the nonrecourse obligation. The Supreme Court sustained the Commissioner's position.

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[46] See 331 U.S. 14, n. 37.

> It reasoned that in light of the Commissioner's long-standing policy, approved in *Crane*, of treating a nonrecourse mortgage "in this context as a true loan," 461 U.S. at 307, with the result that a taxpayer may realize the benefit of depreciation on a purchase financed by nonrecourse debt, it was not unreasonable for the Commissioner to treat the assumption of the nonrecourse debt as part of the selling price in determining the amount realized by a taxpayer upon disposition of the encumbered property even when the unpaid amount of the nonrecourse obligation exceeds the value of the property transferred. The Court's rationale was thus essentially one of symmetry, the concept that if a tax benefit is claimed and allowed from debts incurred under nonrecourse obligations, the taxpayer must treat the transfer of these obligations as part of the consideration for a sale of the property. [*Odend'hal v. Commissioner*, 748 F.2d 908 (4th Cir. 1984), affg. 80 T.C. 588 (1983), cert. denied 471 U.S. ____ (1985).]

There is nothing in *Tufts* to require that the nonrecourse debt in the instant case must be recognized. This is not a case where, having taken depreciation on property on a basis which includes nonrecourse debt incurred in acquisition of the property, a taxpayer seeks to ignore a transfer of the nonrecourse note in computing gain or loss from a subsequent sale of the property.

In addressing an argument similar to the one raised by petitioners, the Court of Appeals for the Fourth Circuit stated:

> We see nothing in Tufts to alter the well-established rules that a taxpayer may not * * * claim an interest deduction where he has neither personal liability nor economic incentive to pay. In reaching these conclusions, we note that while *Tufts* did state that "Crane also stands for the broader proposition * * * that a nonrecourse loan shall be treated as a true loan," 461 U.S. at 313, 103 S. Ct. at 1834, it emphasized that *Crane* was "predicated on the assumption that the mortgage will be repaid in full," i.d. 103 S. Ct. at 1836, and that "the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay." [*Odend'hal v. Commissioner*, 748 F.2d at 913.]

The assumption that the nonrecourse note would be repaid is lacking herein. Petitioners had no economic incentive to repay the said obligation. It follows that petitioners are not entitled to deduct any interest with regard to the nonrecourse note.[47]

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[47] Sec. 183(b)(1) requires an independent determination of allowability with respect to the interest expense.

Petitioners argue, citing *Natco Corp. v. United States*, 240 F.2d 398 (3d Cir. 1956), that where, as in here, the notes provide for payment no later than on a certain date, no contingency exists, and the notes, along with their accompanying interest expense, are deductible. Concededly, the nonrecourse note provided that all unpaid interest and principal was to be due and payable on the 15th anniversary date of the note's execution, and the recourse note was to be paid in installments.[48] However, we do not think, and *Natco Corp. v. United States, supra*, does not support the proposition, that the inclusion of a clause providing that payment of principal and interest is to be made by a certain date causes the disappearance of all contingencies, and guarantees, ipso facto, the accruability of principal and interest.

In *Natco Corp. v. United States, supra*, a corporation, reorganized under the bankruptcy laws, issued debentures to its creditors and proceeded to accrue the unpaid interest on the debentures and to deduct it as an expense for tax purposes. All of the accumulated and current interest was paid; the returns showed no deduction for payment of the accumulated interest, but only for current interest. The taxpayer instituted a proceeding to obtain refund of income taxes, claiming that the accruals were improper and that the deductions should have been taken only in the years of payment. In affirming the District Court's determination that the accruals and deductions in the years prior to payment had been proper for the reason that the debentures and indenture accompanying them had created a definite and fixed liability of the taxpayer for interest, the Court of Appeals for the Third Circuit reasoned that: (1) The provision in the debentures and the indenture that payment of the interest semiannually was to constitute a fixed obligation of the company only after the first mortgage bonds had been retired was intended to defer such payment until that date and not to make the obligation of the company for interest at maturity contingent upon that event; (2) the corporation could redeem the debentures at any time but only upon the payment of the principal and accrued interest to the date of redemption, together with a premium of 5 percent of the principal; (3) upon conversion, the debenture holders were entitled to receive an additional share of stock for each $20 of unpaid accrued interest; (4) the conduct of the taxpayer from the date of the issuance of the debentures clearly indicated that the interest on the debentures was regarded as a fixed liability; and (5) the contingency of payment upon earnings was in turn qualified by the provisions in the debentures and in the indenture that payments of principal and interest were to be made on the maturity date. Thus, this last factor was but one of several factors that were considered by the court in reaching its determination. Likewise, in making our determination, we have considered several factors, with no single one of them being determinative.

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[48] See note 21.

Section 1253(d)(2) prescribes the tax treatment for payments, other than contingent payments within the meaning of section 1253(d)(1), made by transferees of a franchise, where the transfer is not treated as a sale or exchange of capital asset, in discharge of a principal sum agreed upon in the transfer agreement.[49] Section 1253(d)(2)(A) provides that a single payment made in discharge of such principal sum shall be allowed as a deduction ratably over the taxable years in the period beginning with the taxable year in which the payment is made and ending with the shorter of the ninth succeeding taxable year or the last taxable year beginning in the period of the transfer agreement.

Petitioners contend that, pursuant to section 1253(d)(2)(A), they are entitled to amortize and deduct the $35,233.47 paid as an acquisition fee in connection with the TireSaver distributorship, ratably, over a 10-year period, beginning with the year

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[49] Sec. 1253(d)(2) provided as follows during the years in issue:

(2) OTHER PAYMENTS.—If a transfer of a franchise, trademark, or trade name is not (by reason of the application of subsection (a)) treated as a sale or exchange of a capital asset, any payment not described in paragraph (1) which is made in discharge of a principal sum agreed upon in the transfer agreement shall be allowed as a deduction—

(A) in the case of a single payment made in discharge of such principal sum, ratably over the taxable years in the period beginning with the taxable year in which the payment is made and ending with the ninth succeeding taxable year or ending with the last taxable year beginning in the period of the transfer agreement, whichever period is shorter;

(B) in the case of a payment which is one of a series of approximately equal payments made in discharge of such principal sum, which are payable over—

(i) the period of the transfer agreement, or

(ii) a period of more than 10 taxable years, whether ending before or after the end of the period of the transfer agreement,

in the taxable year in which the payment is made; and

(C) in the case of any other payment, in the taxable year or years specified in regulations prescribed by the Secretary, consistently with the preceding provisions of this paragraph.

1978, without regard to the requirements of section 162.[50]

Respondent contends that the payment herein must run the gauntlet of section 162(a). Alternatively, respondent argues that if petitioners are entitled to an amortization deduction with regard to the acquisition fee, the amount allowable is an amount which bears the same ratio to the amount claimed as the portion of the year that the distributorship rights were actually held bears to a full year.

Section 1253(d)(1) specifically provides that amounts paid or incurred as therein described "shall be allowed as a deduction under section 162(a) (relating to trade or business expenses)." Section 1253(d)(2) does not contain a reference to section 162, or to any other section of the Code. Petitioners argue that this is demonstrative of Congress' intent that section 162 be inapplicable to section 1253(d)(2) payments.

The House report, in explaining the provisions of section 1253, states:

> The term "franchise" is defined by the bill to mean a franchise, distributorship, or other like interest. This would include subfranchises, subdistributorships, and other similar exclusive type contract arrangements *to operate or conduct a trade or business*. [H. Rept. 91–413 (1969), 1969–3 C.B. 200, 302; emphasis added.]

The Senate report provides:

> The committee amendments also provide that the term "franchise" includes an agreement which gives one of the parties to the agreement the right to distribute, sell, or provide goods, services, or facilities, within a specified area. This would include distributorships or other similar exclusive-type contract arrangements to *operate or conduct a trade or business* within a specified area, such as a geographical area to which the *business activity of the transferee* is limited by the agreement. However, the committee amendments provide that the new rules are not to apply to the transfer of a franchise to engage in a professional sport. This exception applies only to franchises for teams to participate in a professional sports league, and would not apply to other franchised sports enterprises, such as a franchise to operate a golfing, bowling, or other sporting enterprise *as a trade or business*. * * * [S. Rept. 91–552 (1969), 1969–3 C.B. 423, 557; emphasis added.]

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[50] The next logical step in petitioners' argument is that our determination that the TireSaver activity was not engaged in for profit, as no deductions under sec. 162 are allowable, does not preclude the deduction of amortization or depreciation expenses in connection with the acquisition fee, $35,233.47, paid for the TireSaver distributorship.

Prior to the enactment of section 1253(d)(2), amounts paid as initial fees to acquire a franchise were not deductible by the transferee through depreciation or amortization since franchises were considered to be intangible assets with unascertainable useful lives. See S. Rept. 91-552, *supra* at 555.

The courts, faced with the question of the deductibility of payments by a transferee of a franchise, looked to section 167, and particularly, to section 1.167(a)-3, Income Tax Regs., which sets forth the guidelines for amortization of intangible assets. The deductibility or amortization of payments in connection with the acquisition of franchises depended upon whether the franchise had a reasonably determinable useful life. See *Triangle Publications, Inc. v. Commissioner*, 54 T.C. 138 (1970); *Dunn v. United States*, 259 F. Supp. 828 (W.D. Okla. 1966), affd. 400 F.2d 679 (10th Cir. 1968); *Dairy Queen of Oklahoma, Inc. v. Commissioner*, 250 F.2d 503 (10th Cir. 1957).

Section 1253(d)(2) now provides for the deduction through amortization of such initial or acquisition payments over a period no longer than 10 years. In order for such amounts to be deductible under section 1253(d)(2), however, the taxpayer must be operating or conducting a trade or business after the payments are made. The mere signing of an agreement for the transfer of a franchise or distributorship, and payment of the acquisition or initial fees, do not, ipso facto, entitle the taxpayer to a deduction.[51]

We hold, accordingly, that petitioners are not entitled to the claimed deductions in connection with the acquisition fee.[52]

Finally, having determined that petitioners were not engaged in the TireSaver activity for profit, viz, that they are not entitled to any deductions under section 162(a), or 1253(d), we must now turn to whether section 183 provides petitioners any relief. Section 183(b)(2) allows those deductions which would otherwise be permitted only if the activity was engaged in for profit, but only to the extent that the gross income from the activity exceeds the deductions allowed under subsection (b)(1).[53] As no gross income was ever generated by petitioner's TireSaver activity, section 183(b)(2) is of no benefit to them.

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[51] Initial or acquisition payments by transferees of franchises that do not satisfy the requirements of secs. 1253(a) and 1253(d)(2) are to be treated as under old law; thus, if the transferee has purchased an intangible asset and the requirements of secs. 167 and 1.167(a)-3, Income Tax Regs.,—that the asset be used in the trade or business for only a limited period, the length of which can be estimated with reasonable accuracy—he will be entitled to deductions, otherwise no deductions may be taken. See S. Rept. 91-552 (1969), 1969-3 C.B. 423, 556.

Payments under sec. 1253(d)(1) must also be incurred in the context of a trade or business. We do not think that Congress intended to enact a different standard, exempting initial payments by transferees pursuant to transfers covered by sec. 1253(a) from the general requirement that there be a trade or business.

[52] Petitioners may not deduct any amounts in connection with the promotional expense fees as these were amounts which were to be held in escrow and returned to petitioner upon submittal of a proposal, as specified by the distributor agreement.

To reflect the foregoing,

Decision will be entered for the respondent.

SPURGEON MARSHALL AND ESTATE OF THELMA MARSHALL, DECEASED, SPURGEON MARSHALL, COMMUNITY SURVIVOR, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 6302–79. Filed August 13, 1985.

Held, allegations deemed admitted under Rule 90(c) were sufficient to sustain respondent's deficiency determination, and respondent's motion for summary judgment on that issue is granted. *Held, further,* allegations deemed admitted under Rule 90(c) were sufficient to satisfy respondent's burden of proving fraud, and respondent's motion for summary judgment on that issue is granted.

Ward A. Busey, for the petitioners.

Thomas G. Norman, for the respondent.

OPINION

NIMS, *Judge*: This matter is before the Court on respondent's motion for summary judgment pursuant to Rule 121.[1]

Respondent determined deficiencies in and additions to petitioners' Federal income tax as follows:

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[53] Petitioners obtain no benefit for the provisions of sec. 183(b)(1) as we have determined, *supra,* that the interest expense, dependent on the proper accrual of the notes, is not deductible.

[1] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code of 1954 in effect for the years in question.

Year	*Deficiency*	*Additions to tax sec. 6653(b)*
1974	$14,801.01	$7,400.51
1975	9,314.21	4,657.10

Respondent's motion for summary judgment raises the following issues: (1) Whether petitioners underreported income from the operation of a Gulf service station during the years in issue; and (2) whether petitioners are liable for additions to tax for fraud under section 6653(b).

This matter has been before the Court on four occasions: on February 2, 1983, at which time the Court was advised by respondent's counsel, speaking for both parties, that the case was "close to settlement"—the trial was therefore continued generally; on February 28, 1984, at which time petitioners' counsel (making his only physical appearance in this case) advised the Court that he, petitioners' counsel, was unable to locate his client but would keep trying—the case was again continued generally; on May 2, 1984, at which time the Court was advised that respondent's counsel was unable to make contact with petitioners' counsel—the case was again continued; and on October 22, 1984, at which time respondent argued this motion for summary judgment which had been filed with the Court on June 22, 1984, and served on petitioners on June 26, 1984, along with notice setting respondent's motion for hearing in Houston, Texas, on October 22, 1984. No appearance by or on behalf of petitioners was made, and respondent again advised the Court that he was unable to make contact with petitioners' counsel. The Court received no communication from petitioners' counsel or petitioners in response to the notice of hearing. Likewise, petitioners did not respond in writing to respondent's motion for summary judgment.

On May 14, 1979, petitioners Spurgeon Marshall and Thelma Marshall, husband and wife, filed a petition disputing the income tax deficiencies and additions to tax for fraud set forth in the notice of deficiency.[2] On July 12, 1979, respondent timely filed an answer denying petitioners' assignment of errors and affirmatively alleging that part of petitioners' underpayment of tax for 1974 and 1975 was due to fraud.

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[2] On Aug. 2, 1980, subsequent to the filing of the petition herein, Thelma Marshall died. On Feb. 2, 1983, we granted respondent's motion to substitute the Estate of Thelma Marshall, deceased, Spurgeon Marshall, Community Survivor, for Thelma Marshall.

Petitioners did not file a reply denying the affirmative allegations of fraud in respondent's answer.

On May 11, 1983, and March 30, 1984, respondent served requests for admissions on petitioners' counsel. The admissions requested were the following:

> 1. During each of the taxable years 1974 and 1975, petitioners operated Marshall Gulf Service, a retail establishment located at 1401 Lockwood, Houston, Texas 77020.
>
> 2. During the taxable years 1974 and 1975, petitioners operated Marshall's Tire Service, a retail establishment located at 1401 Lockwood, Houston, Texas 77020.
>
> 3. During the years 1974 and 1975, the principal source of income of Marshall Gulf Service was from the sale of gasoline.
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> 4. During the years 1974 and 1975, the petitioners reported their income on the basis of the cash method of accounting.
>
> 5. During the years 1974 and 1975, the petitioners purchased the gasoline sold by Marshall Gulf Service from the Gulf Oil Corporation.
>
> 6. During the years 1974 and 1975, the petitioners maintained daily sales records on which they recorded an amount stated to be the dollar amount of daily sales for Marshall Gulf Service.
>
> 7. The daily sales records maintained by the petitioners for Marshall Gulf Service for the years 1974 and 1975 omitted substantial amounts of receipts.
>
> 8. During the years 1974 and 1975, the petitioners used documents captioned "Paid Out Slip" on which were recorded amounts stated to have been paid to Gulf Oil Corporation (Gulf) for the gasoline delivered to Marshall Gulf Service.
>
> 9. The paid out slips filled out by the petitioners for Marshall Gulf Service for the years 1974 and 1975 understated the amounts paid to Gulf Oil Corporation for gasoline.
>
> 10. The daily sales records and the paid out slips were given to the bookkeeper for Marshall Gulf Service for the preparation of monthly profit and loss statements. These amounts were subsequently used for the preparation of the petitioners' tax returns for the years 1974 and 1975.
>
> 11. On their income tax returns for the years 1974 and 1975, the petitioners reported gross receipts as follows: 1974 – $340,944.48 and 1975 – $504,703.60.
>
> 12. On their income tax returns for the years 1974 and 1975, the petitioners reported costs of goods sold for Marshall Gulf Service as follows: 1974 – $320,176.76 and 1975 – $481,600.38.
>
> 13. On their income tax returns for the years 1974 and 1975, the petitioners reported purchases for Marshall Gulf Service as follows: 1974 – $317,418.56 and 1975 – $481,404.26.
>
> 14. During the years 1974 and 1975, the Gulf Oil Corporation delivered totals of 1,663,649 and 1,488,394 gallons of gasoline, respectively, to petitioners' place of business.

15. The actual purchases of the gasoline delivered to petitioners' place of business during the years 1974 and 1975 were in the following dollar amounts: 1974 – $668,222.57 and 1975 – $686,353.80.

16. During the years 1974 and 1975, petitioners sold gasoline at an average price of not less than $.04 per gallon more than their cost.

17. During the years 1974 and 1975, the gross receipts from petitioners' Marshall Gulf Service were: 1974 – $737,476.73 and 1975 – $746,085.86.

18. On their federal income tax returns (Forms 1040) for each of the years 1974 and 1975, the petitioners understated their gross receipts from Marshall Gulf Service by at least $396,532.25 for 1974 and by at least $241,382.36 for 1975.

19. On their federal income tax returns (Forms 1040) for each of the years 1974 and 1975, the petitioners understated their cost of goods sold.

20. Petitioners knowingly understated their gross receipts for the years 1974 and 1975.

21. Petitioners knowingly understated their cost of goods sold for the years 1974 and 1975.

22. Petitioners knowingly maintained false records of receipts for the years 1974 and 1975.

23. Petitioners knowingly maintained false records of purchases for the years 1974 and 1975.

24. Petitioners knowingly had their income tax return for the year 1974 prepared from false records maintained by petitioners.

25. Petitioners knowingly had their income tax return for the year 1975 prepared from false records maintained by petitioners.

26. During the years 1974 and 1975, petitioners made payments for personal items out of the cash receipts of Marshall Gulf Service without first reporting the cash so expended as part of the gross receipts of Marshall Gulf Service.

27. The petitioners' fraudulently and with intent to evade tax, omitted from their income tax returns for the taxable years 1974 and 1975, gross receipts of $396,478.25 and $241,382.06, respectively.

28. The petitioners' fraudulently, and with intent to evade tax, understated their purchases on their income tax returns for the years 1974 and 1975 in the amount of $350,754.01 and $204,947.54, respectively.

29. Petitioners fraudulently, and with intent to evade tax, omitted from their income tax returns for the years 1974 and 1975 taxable income in the amounts of $37,724.24 and $27,832.54, respectively.

30. A part of the underpayment of tax required to be shown on petitioners' income tax returns for the taxable years 1974 and 1975 is due to fraud.

Petitioners failed to respond to either set of requests for admissions.

Respondent's motion for summary judgment requests that we sustain the deficiencies and additions to tax for fraud set forth in the notice of deficiency. In his motion, respondent contends that because petitioners failed to respond to the request for admissions served on March 30, 1984, the allega-

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tions contained therein are deemed admitted under Rule 90(c).[3] Respondent concludes that the facts deemed admitted under Rule 90(c) are sufficient to sustain his deficiency determination as well as satisfy his burden of affirmatively proving fraud.

For reasons set forth below, we grant respondent's motion for summary judgment.

Under Rule 121, a summary adjudication may be made "if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." Rule 121(b). The party opposing the motion cannot rest upon the allegations or denials in his pleadings, but must "set forth specific facts showing that there is a genuine issue for trial." Rule 121(d). The moving party, however, bears the burden of proving that there is no genuine issue of material fact, and factual inferences will be read in a manner most favorable to the party opposing summary judgment. *Jacklin v. Commissioner*, 79 T.C. 340, 344 (1982); *Espinoza v. Commissioner*, 78 T.C. 412, 416 (1982).

The first issue for decision is whether we should grant respondent's motion for summary judgment as to the income tax deficiencies for 1974 and 1975.

Respondent's motion for summary judgment as to the income tax deficiencies for the years in issue is supported by his unanswered requests for admissions. Because petitioners failed to respond to respondent's requests for admissions, the facts contained therein are deemed admitted. Rule 90(c); *Freedson v. Commissioner*, 65 T.C. 333, 334–336 (1975). Based on these deemed admissions, we find that respondent has satisfied his burden of proving that no genuine issue of material fact exists as to respondent's deficiency determinations and that respondent is entitled to a decision with respect to his deficiency determinations as a matter of law. Consequently, we grant respondent's motion as to the amount of deficiencies determined in the notice of deficiency.

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[3] Rule 90 provides in pertinent part as follows:

RULE 90. REQUESTS FOR ADMISSION

(a) Scope and Time of Request: A party may serve upon any other party a written request for the admission, for purposes of the pending action only, of the truth of any matters which are not privileged and are relevant to the subject matter involved in the pending action, provided such matters are set forth in the request and relate to statements or opinions of fact or of the application of law to fact, including the genuineness of any documents described in the request. * * *

* * * * * * *

(c) Response to Request: Each matter is deemed admitted unless, within 30 days after service of the request or within such shorter or longer time as the Court may allow, the party to whom the request is directed serves upon the requesting party (i) a written answer specifically admitting or denying the matter involved in whole or in part, or asserting that it cannot be truthfully admitted or denied and setting forth in detail the reasons why this is so, or (ii) an objection, stating in detail the reasons therefor. * * *

* * * * * * *

(e) Effect of Admission: Any matter admitted under this Rule is conclusively established unless the Court on motion permits withdrawal or modification of the admission. * * *

The next issue for decision is whether we should grant respondent's motion for summary judgment as to the additions to tax for fraud under section 6653(b).

Fraud is defined as an intentional wrongdoing designed to evade tax believed to be owing. *Professional Services v. Commissioner*, 79 T.C. 888, 930 (1982). The burden of proof rests on respondent to show by clear and convincing evidence that some portion of the understatement of income for each year was due to fraud with the intent to evade tax. Sec. 7454(a); Rule 142(b).

Respondent, relying on *Doncaster v. Commissioner*, 77 T.C. 334 (1981) (a Court-reviewed opinion), argues that the facts deemed admitted under Rule 90(c) are sufficient to satisfy his burden of proving that some portion of petitioners' understatement of income for each year was due to fraud. We agree.

In *Doncaster*, this Court found that facts deemed admitted under Rule 37(c), were sufficient to satisfy respondent's burden of affirmatively proving fraud. In that case, the petitioner was deemed to have admitted under Rule 37(c) that:

> (h) [He] fraudulently, and with intent to evade tax, omitted taxable income of $22,195.00 from his 1976 federal income tax return.
>
> (i) A part of the underpayment of tax required to be shown on the petitioner's 1976 federal income tax return is due to fraud with intent to evade tax.

In granting respondent's motion for summary judgment as to additions to tax for fraud based on the deemed admissions, the Court pointed to the other allegations in paragraph 7(a) through (g) and stated that "Nothing * * * dictates that we should require respondent to present affirmative evidence of fraud, independent of the deemed admissions [fn. ref. omitted]." *Doncaster v. Commissioner, supra* at 338. To reach this conclusion we stated emphatically:

> So that there will be no misunderstanding, we emphasize that the deemed admissions of the allegations of paragraphs 7(a) through 7(g) are also of importance in respect of respondent's ability to establish his fraud case; he has the burden of proving the facts necessary to show an underpayment (to which the addition to tax for fraud attaches) and may not rely upon petitioner's failure to produce evidence in order to carry his (respondent's) burden in that respect. [77 T. C. at 337–338. Citations omitted.]

In the instant case, petitioners are deemed to have admitted facts which overwhelmingly establish substantial, intentional omissions of taxable income for 1974 and 1975, the taxable years in question. In addition, petitioners are deemed to have admitted the following:

> Petitioners fraudulently, and with intent to evade tax, omitted from their income tax returns for the years 1974 and 1975 taxable income in the amounts of $37,724.24 and $27,832.54, respectively.
>
> A part of the underpayment of tax required to be shown on petitioners' income tax returns for the taxable years 1974 and 1975 is due to fraud.

These admissions are almost identical to the admissions relied on in *Doncaster v. Commissioner, supra*, to sustain respondent's additions to tax for fraud. Although the admissions in the instant case were deemed admitted under Rule 90(c), rather than Rule 37(c), we believe that our reasoning in *Doncaster* is also applicable here. We therefore find that the facts deemed admitted under Rule 90(c) are sufficient to satisfy respondent's burden of proving that some portion of the understatement of income for each year was due to fraud with intent to evade tax.

Accordingly, respondent's motion for summary judgment is granted as to the deficiencies and additions to tax for fraud set forth in the notice of deficiency.

An appropriate order and decision will be entered.

WOODS INVESTMENT COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 6237-83. Filed August 15, 1985.

During all relevant years (1966–78), petitioner was the parent of four wholly owned subsidiaries with which it filed consolidated Federal income tax returns. The subsidiaries used accelerated methods to depreciate their business property. Petitioner sold all of its stock in the subsidiaries on Dec. 13, 1978.

In determining its gain from the sale, petitioner determined its basis in the subsidiaries' stock by reference to the subsidiaries' earnings and profits pursuant to sec. 1.1502–32, Income Tax Regs. In computing the earnings and profits of the subsidiaries, petitioner used the amount of straight-line depreciation pursuant to sec. 312(k), I.R.C. 1954, even though the subsidiaries used accelerated depreciation in computing their taxable income. Respondent determined, however, that petitioner's basis must be further reduced by the amount of accelerated over straight-line depreciation. *Held*, petitioner's basis adjustments are sustained.

Alan Newman, *Richard C. Stark*, *Lawrence B. Gibbs*, *Len Cason*, and *James C. Prince*, for the petitioner.

Thomas J. Miller, *John Broadbent*, and *Virginia Vorhees*, for the respondent.

OPINION

FAY, *Judge*: Respondent determined a deficiency of $3,211,019 in petitioner's 1978 Federal income tax. The only issue is whether petitioner properly computed the basis in its subsidiaries' stock in reporting gain from the sale of the stock.

The facts have been fully stipulated and are so found.

Petitioner Woods Investment Co., a Delaware corporation, had its principal office in Oklahoma City, Oklahoma, at the time it filed the petition herein.

Petitioner is a calendar year taxpayer using the accrual method of accounting. From the date of its formation in 1966 through its taxable year ended December 31, 1978, petitioner was the common parent of an affiliated group of corporations (hereinafter referred to as the group) as defined in section 1504.[1] The group properly filed consolidated Federal income tax returns pursuant to section 1501 for each such taxable year.[2]

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue.

Upon its formation in 1966, petitioner acquired all of the stock of Woods Industries, Inc., a Delaware corporation (WII). WII was a holding company which, in December 1960, acquired all of the stock of United Transports, Inc. (UTI) and Auto Warehousers, Inc. (AWI). UTI and AWI remained wholly owned subsidiaries of WII until 1971 when WII was liquidated. Upon such liquidation, WII distributed all of its assets, including all of its UTI and AWI stock, to petitioner.

UTI and AWI operated petitioner's transportation division which transported new motor vehicles for major domestic manufacturers of cars and trucks between various points in the midwestern and southwestern United States. In addition, it delivered foreign motor vehicles from their port of entry at Houston, Texas, to dealers in 13 states. In 1978, all trucking services were conducted by UTI, which owned all truck tractors and trailers. All rail and other terminals and other real estate used by the transportation division were owned by AWI. On December 12, 1978, the principal assets of UTI were a fleet of approximately 760 diesel-powered over-the-road tractors and trailers, and the principal assets of AWI were the real property utilized by the transportation division.[3] Petitioner owned all of the stock of UTI and AWI until December 12, 1978.

In December 1966, petitioner had also acquired all of the stock of Star Manufacturing Co. of Oklahoma (SMC). SMC was primarily engaged in the business of manufacturing and marketing a broad line of pre-engineered metal building systems for a variety of commercial, industrial, and agricultural uses. Each system was composed of standardized building components, consisting generally of primary structural members and various panels used as roofing and wall coverings. SMC's products are used as manufacturing facilities, shopping centers, office buildings, warehouses, and retail stores. SMC's principal manufacturing facility was a plant located in Oklahoma City, and it had two other plants located in Cedartown, Georgia, and Homer City, Pennsylvania. Major production equipment at all plants consisted of punch presses, roll farming equipment, and automatic welding machines.[4] SMC was a wholly owned subsidiary of petitioner from 1966 through December 12, 1978.

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[2] From Jan. 1, 1979, through the present, petitioner has not been a member of an affiliated group.

[3] During the relevant periods herein, AWI, from time to time, owned all of the stock of certain subsidiaries engaged in various active businesses including selling auto crushing equipment and certain other machinery utilized in the salvaging of junk automobiles.

In 1971, SMC organized Star Realty Management, Inc. (SRM), as its wholly owned subsidiary. SRM was formed to own interests in, and manage, two partnerships that developed, owned, and managed commercial real estate projects. It also conducted a real estate brokerage business through a wholly owned subsidiary. In 1975, all of the SRM stock was distributed to petitioner as a dividend.[5] SRM thus became a wholly owned subsidiary of petitioner, which it remained until December 12, 1978.

UTI, AWI, SMC, and SRM were wholly owned subsidiaries of petitioner until December 12, 1978, and will be referred to herein as "the subsidiaries." The subsidiaries used accelerated methods to depreciate their business property when permitted.[6]

On December 12, 1978, petitioner's shareholders approved the sale of all of the subsidiaries' stock and certain other assets owned by petitioner to WDS, INC., (WDS), a Delaware corporation, in exchange for cash and the assumption of all petitioner's liabilities (herein the sale). Thus, as part of the sale, WDS agreed to assume all Federal and State income taxes payable to petitioner, including those arising as a result of any gain

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[4] During the relevant period herein, SMC conducted portions of its business through wholly owned subsidiaries.

[5] This distribution was made in accordance with sec. 1.1502–14(a)(1), Income Tax Regs.

[6] From 1966 through the taxable year ended Dec. 12, 1978, the subsidiaries had taxable income (loss) as follows:

Taxable year	*UTI*	*AWI*	*SMC*	*SRM*
1966	$663,994	$520,186	. . .	. . .
1967	963,661	588,260	$1,186,200	. . .
1968	1,839,759	821,357	1,967,487	. . .
1969	1,115,278	811,252	3,104,707	. . .
1970	509,907	163,191	810,390	$11,356
1971	1,300,564	1,925,978	1,114,695	(39,567)
1972	1,971,132	1,858,952	3,215,379	(49,705)
1973	1,316,315	3,577,206	2,875,656	(172,163)
1974	(1,017,145)	3,294,055	(282,318)	(150,212)
1975	237,212	2,592,679	(376,881)	(212,985)
1976	1,668,047	1,858,578	1,679,297	(150,262)
1977	1,818,283	658,683	2,511,228	(3,205)
TYE 12/12/78	1,190,963	1,181,748	2,672,181	53,008

recognized from the sale. In determining the total purchase price that it would pay for the assets, WDS needed to ascertain the amount of petitioner's anticipated gain on the sale and resulting Federal income tax liability. Accordingly, petitioner and WDS sought, with the assistance of petitioner's public accounting firm, to calculate petitioner's basis in the stock of the subsidiaries. Such basis was determined to be $24,648,868, and the sale was consummated on December 13, 1978.

On its 1978 return, petitioner reported a long-term capital gain of $1,472,378 on the sale.[7] In his notice of deficiency, respondent determined that petitioner's basis of $24,648,868 in the subsidiaries' stock must be decreased by $7,373,131 and therefore respondent determined that petitioner realized a gain of $12,252,266[8] on the sale.[9]

Thus, we must determine whether petitioner's or respondent's calculation of petitioner's basis in the subsidiaries' stock is correct.[10] Because petitioner filed consolidated returns, our analysis involves the law governing such returns.

Pursuant to section 1502, Congress has given the Secretary of the Treasury broad authority to prescribe regulations with respect to the making of consolidated returns, as follows:

> The Secretary shall prescribe such regulations as he may deem necessary in order that the tax liability of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be returned, determined, computed, assessed, collected, and adjusted, in such manner as to clearly reflect the income tax liability and the various factors necessary for the determination of such liability, and in order to prevent avoidance of such tax liability.

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[7] The amount realized by petitioner from WDS in the sale, excluding the sale of an aircraft for $88,000, was (a) the sum of (i) $30,032,000 in cash, (ii) the assumption of non-tax liabilities of $1,126,513, and (iii) the Federal and State tax liabilities assumed by WDS reduced by (b) expenses attributable to the sale of $295,005.47. If petitioner's calculations of its basis in the stock of the subsidiaries is correct, then the Federal and State tax liabilities assumed by WDS in the sale total $333,080 and $39,733, respectively. If respondent's calculation of basis is correct, then the Federal and State tax liabilities assumed total $3,385,752 and $456,770, respectively.

[8] Respondent's determination of gain on the sale is greater than the amount by which he decreased petitioner's basis due to the increased amount of liabilities assumed by WDS which in turn increases petitioner's amount realized from the sale.

[9] The parties apparently agree that, if we find for petitioner, then petitioner's gain on the sale is $1,033,041 and, if we find for respondent, petitioner's gain is $11,875,881.

[10] Although the parties filed two briefs in this case, the Court heard oral arguments on Mar. 15, 1985, due to the complex nature of the issue herein. In addition, the Court considered an amicus curiae brief filed by John S. Nolan.

The consolidated return regulations promulgated pursuant to section 1502 provide a detailed and comprehensive set of rules for adjusting the basis of a subsidiary's stock held by a parent corporation. Sec. 1.1502–32, Income Tax Regs. Pursuant to section 1.1502–32(a), Income Tax Regs., either a positive or a negative basis adjustment must be made annually to the basis of such stock in an amount equal to the difference between the required "positive adjustment" and the required "negative adjustment." The primary positive adjustment is "An allocable part of the undistributed earnings and profits of the subsidiary for the taxable year." Sec. 1.1502–32(b)(1)(i), Income Tax Regs. Conversely, the primary negative adjustment is "An allocable part of the deficit in earnings and profits of the subsidiary for the taxable year." Sec. 1.1502–32(b)(2)(i), Income Tax Regs.

Pursuant to section 1.1502–32, Income Tax Regs., petitioner first computed the earnings and profits of the subsidiaries and then used those figures to adjust its basis in the subsidiaries' stock. In computing the earnings and profits of the subsidiaries, petitioner followed section 312(k), which provides that, for purposes of computing the earnings and profits of a corporation for any taxable year beginning after June 30, 1972, the allowance for depreciation (and amortization, if any) shall be deemed to be the amount which would be allowable for such year if the straight-line method of depreciation had been used.[11] Thus, pursuant to section 312(k), petitioner reduced its subsidiaries' earnings and profits only by the amount of straight-line depreciation available rather than the amount of accelerated depreciation actually taken on its consolidated returns.

Petitioner argues that its basis adjustments to the subsidiaries' stock are in accordance with section 1.1502–32, Income Tax Regs., that it correctly followed section 312(k) in calculating the subsidiaries' earnings and profits, and that no further adjustments are required by the consolidated regulations which exclusively govern basis adjustments. Respondent concedes that petitioner properly adjusted its basis in the subsidiaries' stock to reflect the subsidiaries' increase or decrease in earnings and profits. Respondent argues, however, that petitioner must further reduce its basis in the subsidiaries' stock for the excess amount of accelerated over straight-line depreciation in order to prevent petitioner from obtaining what respondent perceives to be a "double deduction."[12] Respondent's argument is primarily based on section 1.1016-6(a), Income Tax Regs., which provides that adjustments to basis must always be made to eliminate double deductions or their equivalent, and on *Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), wherein the Supreme Court denied the taxpayer what it found to be the practical equivalent of a double deduction.

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[11] Sec. 312(k) was originally sec. 312(m) under the Tax Reform Act of 1969, but was redesignated as sec. 312(k) by the Tax Reform Act of 1976.

As noted above, Congress has never attempted to enact technical provisions in this area, but rather has given respondent the power to promulgate regulations which govern all taxpayers who file consolidated returns. Secs. 1501 and 1502. Respondent's consolidated return regulations are legislative in character with the force and effect of law. *Georgia-Pacific Corp. v. Commissioner*, 63 T.C. 790, 801-802 (1975). Such regulations will be followed and not overruled by this Court unless clearly contrary to the will of Congress. *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 503 (1948); *Georgia-Pacific Corp. v. Commissioner, supra* at 801.

Pursuant to his delegated power, respondent has promulgated detailed regulations governing the consolidated return area. Among these is section 1.1502-32, Income Tax Regs., which specifically requires each member of a consolidated group owning stock of a subsidiary to "adjust the basis of such stock" in the manner prescribed therein. Sec. 1.1502-32(a), Income Tax Regs. That regulation specifies that the relevant basis adjustments are to be made by reference to a subsidiary's earnings and profits.

The rule of section 1.1502-32, Income Tax Regs., that basis adjustments are to be made in accordance with earnings and profits, rather than taxable income or loss, was first promulgated in 1966. The history of the regulations reveals that respondent's decision to use earnings and profits was a conscious and deliberate one. Prior to 1966, the regulations did not provide for any positive adjustments to a subsidiary's stock, but required a reduction in the basis of a subsidiary's stock measured by the excess of (a) the net operating losses incurred by the subsidiary over (b) the taxable income of the subsidiary against which the net operating losses could have been applied. See sec. 1.1502–34A, Income Tax Regs. Thus, the negative basis adjustment was measured by a subsidiary's taxable losses.

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[12] Respondent contends that petitioner has received a double deduction because petitioner and its subsidiaries received a tax deduction for the excess of accelerated over straight-line depreciation, and, on the disposition of its subsidiaries' stock, since petitioner's basis was not reduced by such excess amount, petitioner realized a second tax advantage in the form of a higher basis which resulted in a lower gain on the sale.

However, on April 30, 1965, the Treasury Department announced that there would be a comprehensive revision of the consolidated return regulations. See T.I.R.-724 (Apr. 30, 1965). When the new consolidated return regulations were first proposed in October 1965, the reduction in basis of a subsidiary's stock was measured by taking the excess of (a) the net operating losses of the subsidiary used by the consolidated group over (b) the earnings and profits of the subsidiary (computed without regard to the subsidiary's net operating losses). Proposed Reg. 1.1502–32, 30 Fed. Reg. 12582 (Oct. 1, 1965). However, this proposed regulation was subsequently withdrawn in September 1966, and a new and different version of section 1.1502–32, Income Tax Regs., was proposed. See 31 Fed. Reg. 11845, 11848 (Sept. 8, 1966). Such version of section 1.1502–32, Income Tax Regs., replaced net operating losses with deficits in earnings and profits as the principal negative adjustment and for the first time provided for a positive adjustment equal to the subsidiary's undistributed earnings and profits for the taxable year. This rule was finally adopted on December 29, 1966, and remains in effect today. See T.D. 6909, 1967–1 C.B. 240, 248.

Respondent chose earnings and profits as the measuring rod for adjusting basis under section 1.1502–32, Income Tax Regs., even though he was well aware that various items and transactions are treated one way in computing taxable income and another way in computing earnings and profits.[13] For example, when section 1.1502–32, Income Tax Regs., was adopted in 1966, a corporation was allowed to deduct the amount of percentage depletion in computing its taxable income, even though it could only reduce its earnings and profits by the lesser amount of cost depletion. See sec. 1.312–6(c)(1), Income Tax Regs. Thus, in the case of a corporation deducting percentage depletion as in the case of a subsidiary using accelerated depreciation, taxable income is reduced by an amount greater than the amount by which earnings and profits are reduced. Nevertheless, despite his awareness in 1966 of the difference between earnings and profits and taxable income, respondent chose earnings and profits as the measuring rod for adjustments to basis and made no special provisions for any differences that did not reduce earnings and profits by the entire amount deducted from taxable income.

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[13] In determining a corporation's earnings and profits, its taxable income must be adjusted for: (1) Certain items excluded from taxable income which must be included in earnings and profits such as interest from State and local obligations (see sec. 1.312–6(b), Income Tax Regs.); (2) certain items deducted in computing taxable income which are not deducted in computing earnings and profits such as the sec. 243 dividends received deduction (see sec. 1.312–11(a), Income Tax Regs.), sec. 172 net operating loss deduction (see sec. 1.312–5(d), Income Tax Regs.), and the excess of percentage depletion over cost depletion (see sec. 1.312–6(c)(1), Income Tax Regs.); and (3) certain items that cannot be deducted in computing taxable income which may be deducted in computing earnings and profits such as Federal income taxes, excess charitable contributions, and nondeduct-

Although section 312(k) was not enacted in 1966, respondent was aware of the interplay between that provision and section 1.1502–32, Income Tax Regs., prior to issuing the notice of deficiency in this case.[14] Respondent had previously issued several technical advice memoranda concerning the identical issue with which we are faced, and, in fact, respondent initially concluded that no further basis adjustment in a subsidiary's stock for the excess of accelerated over straight-line depreciation was required, thus agreeing with petitioner's position herein.[15] In 1982, although respondent changed his position to the one he advances herein,[16] he failed to amend his regulations to reflect his new position.

Based upon the foregoing, we conclude that petitioner reached the result mandated by respondent's consolidated return regulations and section 312(k) in computing its basis in the subsidiaries' stock. We believe that judicial interference

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ible losses (see sec. 1.312–7(b)(1), Income Tax Regs.). See B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 7.03, at 7–16 to 7–23 (4th ed. 1979). See also Rev. Rul. 77–442, 1977–2 C.B. 264.

[14] The notice of deficiency is dated Dec. 21, 1982.

[15] See Technical Advice Memoranda 8206034 (Sept. 12, 1980), 8047027 (Aug. 26, 1980), 7946008 (July 27, 1979), and 7839030 (June 27, 1978). We note that private letter rulings and technical advice memoranda may not be cited for their precedential value, but they "do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws" and may provide "evidence" that such construction "is compelled by the language of the statute." *Hanover Bank v. Commissioner*, 369 U.S. 672, 686–687 (1962). See sec. 6110(j)(3).

[16] See Technical Advice Memorandum 8302014 (Sept. 30, 1982).

sought by respondent is not warranted to alter this result. This Court will apply these regulations and the statute as written. If we were to make a judicial exception with respect to the adjustment for depreciation, we would be opening our doors for respondent every time he was dissatisfied with a certain earnings and profits adjustment.

If respondent believes that his regulations and section 312(k) together cause petitioner to receive a "double deduction," then respondent should use his broad power to amend his regulations. See *Henry C. Beck Builders, Inc. v. Commissioner*, 41 T.C. 616, 628 (1964). Since respondent has not taken steps to amend his regulations, we believe his apparent reluctance to use his broad power in this area does not justify judicial interference in what is essentially a legislative and administrative matter. *Henry C. Beck Builders, Inc. v. Commissioner, supra* (Drennen, J., concurring at page 633).

Moreover, respondent's reliance on *Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934), in support of his position that we should reduce petitioner's basis by the excess amount of accelerated over straight-line depreciation upon the sale of the subsidiaries' stock, is misplaced. In *Ilfeld Co.*, the Supreme Court disallowed the deduction of a corporation's loss on its investments in two subsidiaries with which it had filed consolidated returns upon the liquidation of the subsidiaries. The Court determined that since there were no applicable regulations to allow the deduction, the taxpayer was not entitled to one because it already had the benefit in prior years of offsetting against its income the operating losses of the subsidiaries without reducing its basis in the stock of the subsidiaries. The Supreme Court stated, however, that "in the absence of a provision in the Act or regulations that fairly may be read to authorize it, the deduction claimed is not allowable." *Ilfeld Co. v. Hernandez, supra* at 66. Section 1.1502–32, Income Tax Regs., however, deals comprehensively with this problem by requiring in paragraph (b)(2)(i) that the basis of the stock of the loss subsidiary in the hands of the parent be reduced by any deficit in the earnings and profits. That regulation also prevents a double inclusion in income by providing in paragraph (b)(1)(i) that the basis of the subsidiary's stock be increased by the subsidiary's undistributed earnings and profits. Thus, even assuming petitioner is receiving a double deduction, we believe that the detailed rules in section 1.1502–32, Income Tax Regs., which were prescribed to comprehensively address the problem in *Ilfeld Co.*,[17] together with section 312(k), can fairly be read to authorize the result herein, and, therefore, *Ilfeld Co.* is inapplicable.

Finally, we do not believe that section 1.1016–6(a), Income Tax Regs., requires a contrary result. That regulation provides as follows: "Adjustments must always be made to eliminate double deductions or their equivalent. Thus, in the case of the stock of a subsidiary company, the basis thereof must be properly adjusted for the amount of the subsidiary company's losses for the years in which consolidated returns were made." We do not believe that the language of section 1.1016–6(a), Income Tax Regs., should be read to override the more specific provisions contained in section 1.1502–32, Income Tax Regs. Section 1.1016–6(a), Income Tax Regs., adopted approximately 10 years prior to respondent's amendment of his consolidated return regulations,[18] does not specify what is the requisite "proper adjustment." We find that respondent prescribed in 1966 the proper adjustment to basis when he promulgated specific adjustment rules in section 1.1502–32, Income Tax Regs., and chose earnings and profits to be the exclusive measuring rod. Thus, the "proper adjustment" required by section 1.1016–6(a), Income Tax Regs., is that set forth in section 1.1502–32, Income Tax Regs., which bases the adjustment solely on earnings and profits.

Thus, pursuant to section 1.1502–32, Income Tax Regs., we conclude that petitioner correctly adjusted its basis in the subsidiaries' stock based on the subsidiaries' earnings and profits, which were reduced only by the amount of straight-line depreciation pursuant to section 312(k). Accordingly, no further negative adjustment to petitioner's basis is required.

To reflect concessions and the foregoing,

Decision will be entered under Rule 155.

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[17] See *Covil Insulation Co. v. Commissioner*, 65 T.C. 364, 376 (1975); see also *Garvey, Inc. v. United States*, 1 Cl. Ct. 108, 113 n. 9 (1983), affd. 726 F.2d 1569 (Fed. Cir. 1984).

[18] See 1957–2 C.B. 463, 505.

Reviewed by the Court.

STERRETT, GOFFE, WILBUR, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, GERBER, and WRIGHT, *JJ.*, agree with this opinion.

SIMPSON and SHIELDS, *JJ.*, did not participate in the consideration of this case.

MYRTLE E. RUST, PETITIONER, *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

Docket No. 16199–84. Filed August 15, 1985.

Held, art. XVI of the Agreement in Implementation of Art. IV of the Panama Canal Treaty of 1977, T.I.A.S. Nos. 10030 and 10032, does not exempt U.S. Forces personnel living in the Canal Zone from U.S. income taxation.

Andrew C. Barnard and *George S. Barnard*, for the petitioner.

John N. Strange, for the respondent.

OPINION

FEATHERSTON, *Judge*: This case was assigned to Special Trial Judge Hu S. Vandervort pursuant to section 7456[1] and Rules 180 and 181. The Court agrees with and adopts his opinion which is set forth below.

OPINION OF THE SPECIAL TRIAL JUDGE

VANDERVORT, *Special Trial Judge*: This case is before the Court on respondent's motion for partial summary judgment, filed on May 7, 1985, pursuant to Rule 121.

In the notice of deficiency issued April 4, 1984, respondent determined a deficiency and an addition to tax for the taxable year 1980 as follows:

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[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise noted. All Rule references are to the Tax Court Rules of Practice and Procedure unless otherwise noted.

Year	*Deficiency*	*Sec. 6653(a) addition to tax*
1980	$7,610	$381

Respondent's motion for partial summary judgment raises the issue of whether article XVI of the Agreement in Implementation of Article IV of the Panama Canal Treaty of 1977, T.I.A.S. Nos. 10030 and 10032, provides petitioner with an exemption from the payment of U.S. income taxes, on wages petitioner received from the U.S. Air Force while living in Panama.

Petitioner filed a timely Federal income tax return for the taxable year 1980, while residing in the Republic of Panama c/o PSC Box 856, APO, Miami. On her 1040 form, petitioner reported no income, claiming total exemption due to her membership as a minister of the Trinity Mission Church of California and the Canal Zone (Trinity Mission Church). Attached to the tax return was petitioner's Certificate of Sacredotal Authority, dated June 10, 1980 A.D., and her Form W-2 from the Department of the Air Force, indicating that she had earned income of $30,200.15 in 1980.

On April 4, 1984, respondent issued a notice of deficiency, in response to which petitioner filed the petition to begin this case. In that document, filed May 22, 1984, petitioner contested respondent's determination of a deficiency on the ground that as a member of a religious order, she was neither required to file a return, nor subject to Federal income taxation.

Subsequent to respondent's timely answer, petitioner filed a motion for leave to amend on January 8, 1985. The Court granted the motion. On February 13, 1985, an amended petition was filed. The amended petition reiterated petitioner's position that, as a member of a religious order, she was exempt from taxation. In addition, petitioner claimed that the notice of deficiency was based on the error that respondent overlooked article XVI of the Agreement in Implementation of Article IV of the Panama Canal Treaty of 1977, T.I.A.S. Nos. 10030 and 10032, which according to the petitioner, "provides for tax exemption of income for U.S. employees of the military stationed in the Republic of Panama."

Thereafter, on March 18, 1985, the parties filed a stipulation of settled issue in which petitioner conceded the issue of exemption from taxation by virtue of having taken a vow of poverty or having had her wages assigned to the Trinity Mission Church.

On May 7, 1985, respondent filed the motion for partial summary judgment which is now before the Court for consideration.[2]

Rule 121(b) states that a decision shall be rendered "if the pleadings, * * * and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." The party moving for summary judgment has the burden of demonstrating that no genuine issue as to any material fact exists. *Adickes v. Kress & Co.*, 398 U.S. 144, 157 (1970); *Jacklin v. Commissioner,* 79 T.C. 340, 344 (1982).

Upon careful consideration of the record before us, we find that the facts of this case are not in dispute and that, as a matter of law, article XVI of the Agreement in Implementation of Article IV of the Panama Canal Treaty of 1977, T.I.A.S. Nos. 10030 and 10032, provides an exemption for employees of the U.S. Forces *only* from the payment of *Panamanian* income tax.

On September 7, 1977, the United States and the Republic of Panama signed the Panama Canal Treaty (the treaty), T.I.A.S. No. 10030,[3] and the treaty concerning the Permanent Neutrality and Operation of the Panama Canal, T.I.A.S. No. 10029. These treaties were signed in order to gradually restore to the Republic of Panama full sovereign control over the Panama Canal and the Canal Zone.

Article I of the treaty establishes the Republic of Panama as territorial sovereign of the Canal Zone, with rights to regulate "manage, operate, maintain, improve, protect and defend the Canal" reserved in favor of the United States.

Article III of the treaty vests Canal operation and management in the Panama Canal Commission, a U.S. agency.[4]

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[2] One issue remains in this case. Respondent, in the notice of deficiency, asserted a sec. 6653(a) addition to tax for negligence, the resolution of which will not be determined by a grant or denial of the present motion.

[3] The effective date of the Panama Canal Treaty of 1977 and the accompanying agreements was Oct. 1, 1979, T.I.A.S. No. 10030; *Billman v. Commissioner*, 83 T.C. 534, 541 n. 6 (1984); *McCain v. Commissioner*, 81 T.C. 918, 920 (1983).

[4] Par. 9 of art. III provides that the "rights and legal status of United States Government agencies and employees operating in the Republic of Panama pursuant to this Article, shall be governed by the Agreement in Implementation of this Article." With regard to taxation, art. XV of the agreement in Implementation of Article III of the treaty states the following:

Article IV provides for the protection and defense of the Canal by the United States.[5] Article IV, paragraph 2 of the treaty provides:

> 2. For the duration of this Treaty, the United States of America shall have primary responsibility to protect and defend the Canal. The rights of the United States of America to station, train, and move military forces within the Republic of Panama are described in the *Agreement in Implementation of this Article,* signed this date. The use of areas and installations and *the legal status of the armed forces of the United States of America in the Republic of Panama shall be governed by the aforesaid Agreement.*

ARTICLE XV
Taxation

1. By virtue of this Agreement, the Commission, its contractors and subcontractors, are exempt from payment in the Republic of Panama of all taxes, fees or other charges on their activities or property.

2. *United States citizen employees and dependents shall be exempt from any taxes, fees, or other charges on income received as a result of their work for the Commission.* Similarly, they shall be exempt from payment of taxes, fees or other charges on income derived from sources outside the Republic of Panama.

3. United States citizen employees and dependents shall be exempt from taxes, fees or other charges on gifts or inheritance or on personal property, the presence of which within the territory of the Republic of Panama is due solely to the stay therein of such persons on account of their or their sponsor's work with the Commission.

4. The Coordinating Committee may establish such regulations as may be appropriate for the implementation of this Article.

[Emphasis added.]

This Court has interpreted this provision to provide that U.S. citizen employees of the Canal Commission shall be exempt from taxation *by Panama,* on income received as a result of employment with the Canal Commission. *Smith v. Commissioner,* 83 T.C. 702, 706-710 (1984); *McCain v. Commissioner,* 81 T.C. 918, 929 (1983). It does not exempt Canal Commission employees from the payment of U.S. income tax. *Smith v. Commissioner, supra; McCain v. Commissioner, supra.* The same conclusion has been reached by numerous other courts. *Coplin v. United States,* 761 F.2d 688 (Fed. Cir. 1985), revg. 6 Cl. Ct. 115 (1984); *Corliss v. United States,* 567 F. Supp. 162 (W.D. Ark. 1983); *Highley v. United States,* 574 F. Supp. 715 (M.D. Tenn. 1983); *Hollowell v. United States,* an unreported case (M.D. Fla. 1983, 53 AFTR 2d 84-698, 84-1 USTC par. 9142); *Pierpont v. United States,* an unreported case (D. S.C. 1983, 52 AFTR 2d 83-6198, 83-2 USTC par. 9647); *Snider v. United States,* an unreported case (W.D. Wash. 1983, 53 AFTR 2d 84-349, 84-1 USTC par. 9140); *Stabler v. United States,* an unreported case (N.D. Tex. 1983, 53 AFTR 2d 84-1156, 84-1 USTC par. 9153). But see *Harris v. United States,* 585 F. Supp. 862 (S.D. Ga. 1984).

However, the provision before the Court today is not art. III of the treaty, but art. IV.

[5] There are two executive agreements which serve to implement arts. III and IV of the Panama Canal Treaty. The Agreement in Implementation of art. III has been the focus of this Court's prior inquiries regarding the alleged tax-exempt status conferred on U.S. citizen employees of the Canal Commission residing in the Republic of Panama. See *Smith v. Commissioner,* 83 T.C. 702 (1984), and the cases cited within; see also note 4 *supra.*

Currently, however, our focus is on the Agreement in Implementation of Article IV of the treaty. We are unaware, through our own search and that of the parties involved, of any other court's having yet considered this agreement and its impact on the taxation of U.S. Forces personnel living in the Canal Zone. We do note, however, that the language pertaining to taxation in both agreements is similar, although not exact. See T.I.A.S. Nos. 10031 and 10032.

The Agreement in Implementation of Article IV of the treaty contains article XVI pertaining to taxation. Article XVI, in its entirety, is as follows:

> ARTICLE XVI
>
> *Taxation*
>
> (1) By virtue of this Agreement, the United States Forces are exempt from payment in the Republic of Panama of all taxes, fees or other charges on their activities or property, including those imposed through contractors or subcontractors.
>
> (2) *Members of the Forces or the civilian component, and dependents, shall be exempt from any taxes, fees, or other charges on income received as a result of their work for the United States Forces or for any of the service facilities referred to in Articles XI or XVIII of this Agreement. Similarly, as is provided by Panamanian law, they shall be exempt from payment of taxes, fees or other charges on income derived from sources outside the Republic of Panama.*
>
> (3) Members of the Forces or the civilian component, and dependents, shall be exempt from taxes, fees or other charges on gifts or inheritance or on personal property, the presence of which within the territory of the Republic of Panama is due solely to the stay therein of such persons on account of their or their sponsor's work with the United States Forces.
>
> [Emphasis supplied.]

Petitioner takes the position that her wages, earned as an employee of the U.S. Air Force during the taxable year 1980, are exempt from U.S. income tax pursuant to the "shall be exempt from any taxes" language of article XVI, paragraph 2, of the Agreement in Implementation of Article IV of the treaty, T.I.A.S. No. 10032.

In construing a treaty, courts should give great weight to the meaning ascribed by the Government departments charged with negotiation and enforcement of the treaty. *Kolovrat v. Oregon,* 366 U.S. 187, 194 (1961); *Factor v. Laubenheimer,* 290 U.S. 276, 295 (1933); *State of Minnesota v. Block,* 660 F.2d 1240, 1258 (8th Cir. 1981). Any effort to ascertain the intent of the parties to any agreement must begin with the language in the agreement itself. The plain meaning of treaty language controls unless "application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories." *Sumitomo Shoji America, Inc. v. Avagliano,* 457 U.S. 176, 180 (1982), quoting *Maximov v. United States,* 373 U.S. 49, 54 (1963).

We believe the following interpretation to be the plain meaning of article XVI. Paragraph 1 sets out the purpose of article XVI, to exempt U.S. Forces from the payment of Panamanian taxes, fees, or other charges on their activity or property. Paragraph 2 addresses the specific exemption from *income* taxation while paragraph 3 provides a specific exemption from *gift, inheritance,* and *personal property* taxation by the Republic of Panama.

The confusion surrounding the meaning of article XVI arises only when petitioner isolates the "any taxes" wording of paragraph 2 from the remaining language of article XVI. When article XVI is read, in its entirety, it is clear that the parties were referring only to the application of Panamanian taxes to U.S. Forces personnel. Although we think that this was the actual intent of the signatories to the treaty and accompanying agreements, we do recognize the potential ambiguity created by the use of the "any taxes" language in paragraph 2 of article XVI of the Agreement in Implementation of Article IV of the treaty.

When the language of the treaty is ambiguous or lends itself to more than one construction, the legislative history of the treaty and negotiations may be scrutinized to ascertain the intent of the parties. *Nielsen v. Johnson,* 279 U.S. 47, 52 (1929); *Hidalgo County Water Control & Imp. Dist. v. Hedrick,* 226 F.2d 1, 8 (5th Cir. 1955).

Such legislative history is found in the Committee on Foreign Relations Report on the Panama Canal Treaties, Exec. Rept. 95–12, 95th Cong., 1st Sess. (1978). The report contains a section-by-section analysis of the treaty and implementing agreements.[6] With respect to article XVI, paragraph 2 of the Agreement in Implementation of Article IV (Exec. Rept. 95–12, at 168), the report states:

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[6] The introduction to the report states that:

"These analyses were prepared by members of the treaty negotiating team and have been approved by the offices of the State and Defense Departments directly involved in the negotiations, including the Panama Canal Company. Accordingly, these comments may be considered as an authoritative source of information with respect to the negotiating background and interpretation of the Treaties. [Exec. Rept. 95–12, at 127.]"

> *Article XVI*
>
> This Article exempts certain categories of property and activities from Panamanian taxation. Other property and activities not so specified will be subject to taxation in accordance with Panamanian law.
>
> * * * * * * *
>
> Paragraph (2) exempts members of the Forces and the civilian component, and dependents from the imposition *by Panama* of taxes on income received as a result of their work with the United States Forces * * * on income derived from sources outside Panama. Such persons are subject, however, to Panamanian taxation of any income derived from sources within Panama, other than their employment with the United States Government. [Emphasis supplied.]

From the foregoing it is clear that the United States intended to negotiate only over the imposition of Panamanian taxes on U.S. Forces personnel in the Canal Zone. A similar intention by the Republic of Panama is evidenced by a diplomatic note from the Panamanian Minister of Foreign Relations, Fernando Cardoze Fabrega.[7] See *Coplin v. United States,* 761 F.2d 688 (Fed. Cir. 1985), revg. 6 Cl. Ct. 115 (1984).

> I have the honor to refer to Article 15(2) of the Agreement in Implementation of Article III and to Article 16(2) of the Agreement in Implementation of Article IV of the Panama Canal Treaty of 1977.
>
> I have consulted with Drs. Romulo Escobar Bethancourt, Aristides Royo, Adolfo Ahumada, and Jaime Arias Calderon, Panamanian negotiators of those agreements, and they have confirmed to me that the provisions referred to above were discussed, negotiated, and *drafted exclusively with respect to the tax exemptions that the Republic of Panama would grant to United States-citizen employees of the Panama Canal Commission and their dependents and to members of the United States Armed Forces and the civilian component and their dependents.* The aforementioned provisions resulted from negotiations which did not deal with the United States authority to tax the individuals mentioned therein.
>
> The foregoing expresses the scope of the aforementioned provisions and also represents the interpretation of this Ministry.
>
> [Emphasis added.]

After examination of the treaty and the accompanying agreements, the legislative history, and diplomatic correspondence, we are convinced that the language "exempt from any taxes," in paragraph 2 of article XVI, refers only to Panamanian taxes. The parties to the treaty, the United States and the Republic of Panama, are in agreement with this interpretation.

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[7] We have taken judicial notice of these documents. Fed. R. Evid. 201. Trials before this Court are conducted in accordance with the Fed. R. Evid., 28 U.S.C. app., the rules of evidence applicable in trials without jury in the U.S. District Court for the District of Columbia. Sec. 7453; Rule 143(a); Red. R. Evid. 101.

In view of the foregoing, we hold that the treaty and Agreement in Implementation of Article IV do not exempt petitioner's income from taxation by the United States. As a U.S. citizen, petitioner is taxable by the United States on her income from the U.S. Air Force for the year 1980.[8]

An appropriate order will be issued.

WILLIAM L. BECKER, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 8498–80. Filed August 15, 1985.

On remand from the Court of Appeals for the Third Circuit (751 F.2d 146 (1984)): *Held*, the distinction created by the Commissioner in Rev. Rul. 80–173, 1980–2 C.B. 60, between educational expenses for flight training and certain other educational expenses of veterans is not devoid of a rational basis. *Manocchio v. Commissioner*, 78 T.C. 989 (1982), affd. 710 F.2d 1400 (9th Cir. 1983), followed.

William L. Becker, pro se.[1]
Thomas G. Norman, for the respondent.

SUPPLEMENTAL OPINION

DAWSON, *Judge*: This case is now before us on remand from the Court of Appeals for the Third Circuit. In our earlier opinion, T.C. Memo. 1983–94, we held that petitioner is not entitled to an educational expense deduction under section

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[8] It is a well-settled rule that U.S. citizens are subject to income taxation by the United States on their worldwide income. Sec. 1.1–1(b) Income Tax Regs.; *Cook v. Tait*, 265 U.S. 47 (1924); *Filler v. Commissioner*, 74 T.C. 406, 410 (1980). We need not discuss this rule in light of our finding that the Panama Canal Treaty does not purport to exempt U.S. citizens from the payment of income tax to the United States. But see *Swearingen v. United States*, 565 F. Supp. 1019, 1021 (D. Colo. 1983).

[1] A brief amicus curiae was filed by William E. Frantz and John B. Gratten, as attorneys for Willard K. Baker, who is the taxpayer in *Baker v. United States*, 748 F.2d 1465 (11th Cir. 1984), a case that involves the same issue as this case.

162[2] for the cost of a flight-training course for which he received nontaxable reimbursement from the Veterans' Administration (VA). In rejecting petitioner's arguments that the expenses were deductible, we applied the case of *Manocchio v. Commissioner*, 78 T.C. 989 (1982), affd. 710 F.2d 1400 (9th Cir. 1983), wherein we held that (1) the deduction claimed by the taxpayer-veteran for reimbursed flight-training expenses was disallowed by section 265(1), and (2) the Commissioner was not estopped from disallowing the deduction.

Like the taxpayer in *Manocchio*, petitioner's reimbursement for flight-training expenses was authorized by 38 U.S.C. sec. 1677 (1976) (repealed in 1981), which permits eligible veterans to receive an educational assistance allowance equal to 90 percent of the expenses incurred for approved flight-training courses. Petitioner excluded the payments from income on his 1976 and 1977 Federal income tax returns under 38 U.S.C. sec. 3101(a) (1976), which provides an exemption from taxation for payments of benefits made under any law administered by the VA.

On the appeal of this case, the Third Circuit Court of Appeals concluded that section 265(1) prohibits the deduction in question and that respondent is not estopped from disallowing the deduction. The Court of Appeals, however, did not affirm but vacated our decision and remanded this case—

> solely to afford the taxpayer an opportunity to present to the Tax Court his contention that the Tax Court erred in not finding that the Commissioner abused his discretion in applying Revenue Ruling 80-173 retroactively as to him in violation of the taxpayer's right to equal treatment in the application of the tax laws. [*Becker v. Commissioner*, 751 F.2d 146, 152 (1984).]

In our consideration of the equal treatment issue, we were also directed to specifically consider the effect of Rev. Rul. 83-3, 1983-1 C.B. 72, on this issue. The Court of Appeals stated as follows:

> at the time that *Manocchio* was decided by the Tax Court, the Commissioner had not issued Revenue Ruling 83-3 which disallowed the deduction of educational expenses that were allocable to a portion of the veterans' educational benefits other than flight training. This ruling, however, was prospective only. After the Tax Court had rendered its decision in this case,

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during 1976 and 1977, the taxable years in issue.

> the Courts of Appeals for the Ninth and Eleventh Circuits reached different conclusions as to whether the application of Revenue Rulings 80–173 and 83–3 have resulted in the disparate treatment of similarly situated taxpayers. *Manocchio v. Commissioner*, 710 F.2d 1400, 1404 & n. 2 (9th Cir. 1983) (holding that there is a rational basis for the distinction); *Baker v. United States*, 748 F.2d 1465 (11th Cir. 1984) (holding that there is no rational reason for the retroactive application of 80–173 and the prospective application of 83–3). Thus, there may be some question as to the soundness of the Tax Court's reliance on *Manocchio* due to the Commissioner's subsequent revenue ruling. [751 F.2d at 151–152.]

We begin our analysis of the equal treatment issue by discussing respondent's rulings. At the time petitioner filed his 1976 and 1977 returns, Rev. Rul. 62–213, 1962–2 C.B. 59, revoked by Rev. Rul. 83–3, *supra*, was still in effect. Rev. Rul. 62–213 announced respondent's published position regarding the deductibility of any educational expenses incurred by veterans as follows:

> expenses for education, paid or incurred by veterans, which are properly deductible for Federal income tax purposes, are not required to be reduced by the nontaxable payments received during the taxable year from the Veterans' Administration. [1962–2 C.B. at 59.]

After reconsidering the deductibility of veterans' educational expenses, respondent issued Rev. Rul. 80–173, 1980–2 C.B. 60, which announced that flight training expenses for which veterans receive reimbursement under 38 U.S.C. sec. 1677, like petitioner herein, are not deductible under section 162. Rev. Rul. 80–173 focused upon reimbursement payments under 38 U.S.C. sec. 1677, as follows:

> This holding applies only to reimbursement payments made under 38 U.S.C. section 1677. For treatment of subsistence and educational allowance payments made under 38 U.S.C. section 1681 (1976), which are not reimbursement payments determined by reference to amounts actually expended for tuition and fees, but rather are in the nature of a living stipend determined without regard to amounts expended, see Rev. Rul. 62–213, 1962–2 C.B. 59. [1980–2 C.B. at 61.]

Rev. Rul. 80–173 applied retroactively and, thus, formed the basis for the notice of deficiency sent to petitioner in this case.

Respondent's issuance of Rev. Rul. 83–3, 1983–1 C.B. 72, completes the rulings scenario.[3] Rev. Rul. 83–3 revoked Rev.

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[3] At the time our opinion in *Manocchio v. Commissioner*, 78 T.C. 989 (1982), affd. 710 F.2d 1400

Rul. 62–213, *supra*, and announced, in part, that a deduction otherwise allowable under section 162 for educational expenses must be reduced "to the extent the expense is allocable to the amounts received for such expenses from the Veterans' Administration." 1983–1 C.B. at 73. As authority for his position, respondent relied upon section 265(1), which provides, in part, that no deduction shall be allowed for any amount otherwise allowable as a deduction that is allocable to one or more classes of income other than interest wholly exempt from taxes imposed by subtitle A. Rev. Rul. 83–3, however, was applied prospectively only to the VA allowance attributable in part to educational costs and in part to a veteran's subsistence expenses. With respect to reimbursement *solely* attributable to educational expenses (such as the situation covered by Rev. Rul. 80–173), Rev. Rul. 83-3 was applied retroactively.

The Commissioner has discretion to determine the extent to which a revenue ruling will be applied retroactively. His action in applying a ruling retroactively is reviewable for an abuse of discretion. *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 184 (1957) The Commissioner may be held to have abused his discretion where the circumstances reveal an unfair disparity in his treatment of similarly situated taxpayers. *Dixon v. United States*, 381 U.S. 68, 76–77 (1965); *Farmers' & Merchants' Bank v. United States*, 476 F.2d 406, 409 (4th Cir. 1973); *International Business Machines Corp. v. United States*, 343 F.2d 914, 920 (Ct. Cl. 1965). "The Commissioner cannot tax one and not tax another without some rational basis for the difference." *United States v. Kaiser*, 363 U.S. 299, 308 (1960) (Frankfurter, J., concurring).

In *Dixon v. United States, supra*, the taxpayers purchased notes in reliance upon the Commissioner's acquiescence in a Tax Court decision that allowed capital gain treatment upon the retirement of certain notes to an amount corresponding to original issue discount. The Commissioner then withdrew his acquiescence. The withdrawal was retroactive in general but prospective as to the notes in issue in the Tax Court case. The taxpayers in *Dixon* argued that the Commissioner abused his discretion in applying the withdrawal of the acquiescence

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(9th Cir. 1983), was filed, Rev. Rul. 83–3, 1983–1 C.B. 72, had not yet been issued. The Ninth Circuit Court of Appeals, however, specifically mentioned Rev. Rul. 83–3 in its affirmance.

retroactively, in part, on the ground that the Commissioner set up an unreasonable and arbitrary classification because, they contended, there was no significant difference between the notes they purchased, to which the nonacquiescence applied retroactively, and the notes in issue in the Tax Court decision, to which the nonacquiescence applied prospectively. The Supreme Court examined the Commissioner's justification for the distinction. Rather than deciding the merits of the Commissioner's distinction, the Supreme Court gave it substantial deference. "[W]e cannot say that the distinction was so devoid of rational basis that we must now overturn the Commissioner's judgment." 381 U.S. at 79.

In the instant case, after publishing Rev. Rul. 80–173, which modified Rev. Rul. 62–213, the Commissioner provided for two types of treatment for VA educational assistance: (1) Payments under 38 U.S.C. sec. 1677 (and like payments) which reduce the business educational expense deduction; and (2) payments under 38 U.S.C. sec. 1681, in the nature of a "living stipend" determined without regard to education costs, which do not reduce the business educational expense deduction. In *Manocchio*, this Court found no merit in the taxpayer's argument that the Commissioner unfairly discriminated against taxpayers receiving payments under 38 U.S.C. sec. 1677 by establishing these two categories. We stated as follows:

> Given the fundamental differences in the way these benefits are computed, we cannot say that respondent's decision to treat them differently for tax purposes is "so devoid of rational basis" as to constitute an abuse of discretion. See *Dixon v. United States, supra* at 79. [78 T.C. at 1002–1003.]

The Court of Appeals for the Ninth Circuit affirmed our opinion in *Manocchio* on the issue of whether the Commissioner's retroactive application of Rev. Rul. 80–173 made an impermissible distinction. *Manocchio v. Commissioner*, 710 F.2d at 1404. Upon further consideration of this issue we adhere to our prior conclusion and agree with the Ninth Circuit rather than with the Eleventh Circuit in *Baker v. United States*, 748 F.2d 1465 (11th Cir. 1984), which takes a contrary position.[4]

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[4] *Rivers v. Commissioner*, 727 F.2d 1103 (4th Cir. 1984), affg. without published opinion a Memorandum Opinion of this Court, and *Olszewski v. Commissioner*, an unpublished opinion (1st Cir. 1983, 55 AFTR 2d 85–536), affg. a Memorandum Opinion of this Court, also have upheld the retroactive application of Rev. Rul. 80–173, 1980–2 C.B. 60.

Under 38 U.S.C. sec. 1681(a), the VA is authorized to pay an educational assistance allowance to meet, in part, the expenses of subsistence, tuition, fees, books, and other educational costs. In order to obtain educational assistance for flight training under 38 U.S.C. sec. 1677, the eligible veteran must, among other things, take approved flight school courses. 38 U.S.C. sec. 1677(a). This allowance is computed at the rate of 90 percent of the charges for tuition and fees that similarly situated nonveterans pay for the same flight course. 38 U.S.C. sec. 1677(b). The computation of certain other educational assistance allowances (not including flight training) is provided in 38 U.S.C. sec. 1682. The computations, in general, are based upon the veteran's enrollment status and the number of a veteran's dependents, rather than the costs of tuition and fees.[5] We think that this computational difference shows that respondent's distinction between these two types of payments is not devoid of a rational basis.

In Rev. Rul. 80–173, respondent took the position that, because the tuition and fees for flight training expenses are directly reimbursed by the VA, the reimbursed flight training expenses are not deductible based upon the well-established principle that a business expense is not deductible if it has been or will be reimbursed. See *Canelo v. Commissioner*, 447 F.2d 484 (9th Cir. 1971), affg. per curiam 53 T.C. 217 (1969); *Wolfers v. Commissioner*, 69 T.C. 975, 983–985 (1978); *Charles Baloian Co. v. Commissioner*, 68 T.C. 620, 626 (1977), affd. in an unpublished opinion (9th Cir. 1982). This rule may not be applicable, however, to the other types of payments because such payments are not solely reimbursement for tuition and fees but include a stipend for living expenses. As to these payments, the otherwise deductible expenses that are allocable to tax-exempt income are not deductible by virtue of section 265(1).[6] The fact that respondent's distinction is not devoid of a rational basis, *for tax purposes*, is illustrated by the amount of the net deductible expense. The deduction for educational expenses for flight training is reduced by the full amount of the reimbursement computed under 38 U.S.C. sec. 1677. The deduction for other educational expenses for which non-reimbursement payments are received from the VA is reduced by a lesser amount, such as 50 percent of the payment. Rev. Rul. 83–3, *supra*.[7]

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[5] As pointed out in the amicus brief, certain educational benefits, other than those for flight training, may be computed using a formula based upon the costs of tuition and fees to nonveteran students enrolled in the same program. See, e.g., 38 U.S.C. sec. 1682(b) (1976) (assistance for a veteran pursuing a program of education while on active duty or on less than half-time basis); 38 U.S.C. sec. 1786 (1976) (assistance for a veteran taking correspondence courses). Such educational assistance payments were not specifically addressed in either Rev. Rul. 80–173, *supra*, or Rev. Rul. 83–3, *supra*, and we, therefore, need not discuss respondent's treatment of the deductibility of the expenses to which such reimbursement relates.

[6] We are not unmindful of the fact that in *Manocchio v. Commissioner*, *supra*, we based our holding on sec. 265(1) rather than on the rationale of (*Wolfers v. Commissioner*, 69 T.C. 975,

In *Baker v. United States*, 748 F.2d 1465 (11th Cir. 1984), the 11th Circuit Court of Appeals held that it was an abuse of discretion for the Commissioner to apply Rev. Rul. 80–173 retroactively and Rev. Rul. 83–3 prospectively because the distinction drawn by the Commissioner between the two types of educational benefits had no rational basis. The facts in *Baker* were in all significant respects the same as those in *Manocchio* and in the instant case. The Court of Appeals in *Baker* analyzed the statutory scheme of the educational assistance allowance for veterans and concluded that "Congress created but one educational assistance allowance, the recipients of which should be afforded similar treatment for tax purposes." 748 F.2d at 1468. It is our view that the 11th Circuit, by concentrating on title 38, overlooked the crucial issue of whether, *for tax purposes*, the distinction drawn by the Commissioner was devoid of a rational basis. The 11th Circuit essentially ignored the computational difference. We think that difference provides justification for the distinction because, in the case of flight-training expenses, it ties the payment to the expense. We agree with the Ninth Circuit that—

> it is the *reimbursement* that makes the flight training expenses nondeductible, rather than the mere fact that the benefit is associated with veterans'

983–985 (1978), and cases cited in text above. While we thought our approach was more direct and appropriate, we noted that the result in *Wolfers* was sound. *Manocchio v. Commissioner*, 78 T.C. at 998. In fact, in affirming our decision in *Manocchio*, the Ninth Circuit preferred to rest its decision on the definition of an expense under sec. 162(a), rather than on sec. 265(1). Regardless of which rationale is more appropriate, we think the crucial factor is that the distinction drawn by respondent in Rev. Rul. 80–173, *supra*, between the two types of payments based upon the reimbursement theory is not devoid of a rational basis. As the Supreme Court has said:

> "It is not for us to pass upon the wisdom of any such distinction. It suffices that on this record we cannot say that the distinction was so devoid of rational basis that we must now overturn the Commissioner's judgment. [*Dixon v. United States*, 381 U.S. 68, 79 (1965).]"

[7] We are not here expressing approval of respondent's allocation method since that issue is not currently before us.

education benefit. [*Manocchio v. Commissioner*, 710 F.2d at 1404; fn. ref. omitted; emphasis added.]

In our analysis we have concentrated on Rev. Rul. 80–173 rather than on Rev. Rul. 83–3. However, we have not disregarded the Third Circuit's mandate to consider the effect of Rev. Rul. 83–3. We have focused particularly on Rev. Rul. 80–173 because it is in that ruling that respondent creates the distinction between two types of educational assistance payments. Rev. Rul. 83–3 merely carries forward the distinction. We think that the effect of Rev. Rul. 83–3, if any, is to provide support for the conclusion that respondent's distinction is not devoid of a rational basis. In fact, the fairness of respondent's determination in the earlier ruling may be bolstered by Rev. Rul. 83–3. *Manocchio v. Commissioner*, 710 F.2d at 1404 n. 3. This is so, because Rev. Rul. 83–3 makes at least some portion of *all* educational expenses subject to VA benefits nondeductible. Moreover, since we have found that the distinction created by respondent in Rev. Rul. 80–173 is not devoid of a rational basis, we fail to see how Rev. Rul. 83–3, which was subsequently published, can negate that finding.

Decision will entered for the respondent.

Reviewed by the Court.

STERRETT, SIMPSON, WILBUR, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, CLAPP, JACOBS, and WRIGHT, *JJ.*, agree with the majority opinion.

SWIFT and GERBER, *JJ.*, did not participate in the consideration of this case.

GOFFE, *J.*, dissenting. I respectfully dissent. I agree with the holding in *Baker v. United States*, 748 F.2d 1465 (11th Cir. 1984). In my view, the retroactive revocation of a published ruling, even if it technically does not constitute an abuse of discretion, is perceived by the taxpayers as so unfair, that it at least represents extremely poor judgment.

The Commissioner has set forth the objectives and standards of published revenue rulings in Rev. Proc. 78–24, 1978–2 C.B. 503:

> SEC. 3. DEFINITIONS.
>
> 01. A "revenue ruling" is an official interpretation of the Internal Revenue laws, related statutes, tax treaties, and regulations, by the Internal Revenue Service that has been published in the Internal Revenue Bulletin. Revenue rulings are issued only by the National Office and are published for the information and *guidance of taxpayers*, Service officials, and others concerned. [Emphasis added.]
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> * * * * * * *
>
> SEC. 5. OBJECTIVES.
>
> The *purpose* of publication of revenue rulings and revenue procedures in the Internal Revenue Bulletin is *to promote uniform application of the tax laws* by Internal Revenue Service employees and *to assist taxpayers in attaining maximum voluntary compliance* by informing Service personnel and the public of National Office interpretations of the internal revenue laws, related statutes, tax treaties, and regulations, and statements of Service procedures affecting the rights and duties of taxpayers. [Emphasis added.]
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> * * * * * * *
>
> SEC. 7. FORM AND EFFECT OF PUBLICATION.
>
> 01. Revenue Rulings. * * *
>
> (5) Taxpayers generally may rely upon revenue rulings published in the Bulletin in determining the tax treatment of their own transactions and need not request specific rulings applying the principles of a published revenue ruling to the facts of their particular cases. * * *

The excerpts are included to state the policies of the Commissioner regarding published rulings. They are not cited to show whether the unwary taxpayer who relies upon a published revenue ruling is on notice as to the possibility that a ruling may be revoked retroactively.

If the Commissioner wants to encourage taxpayers to voluntarily comply with the tax law, which indeed all of us who are concerned with the administration of the tax laws should want, he should accord greater weight to that factor than the relatively insignificant loss of revenue occasioned by prospective revocation. The perception of the taxpayers who have appeared before me in these cases is that they have received unfair treatment by the Commissioner, and I find it difficult to argue with their logic. These taxpayers attempted to file correct income tax returns in abiding by a ruling published by the Commissioner, only to find several years later that the Commissioner changed his mind. Such action by the Commissioner requires that the taxpayers either concede or litigate the point and pay not only the tax but accrued interest as well. I agree with the taxpayers that this is unfair treatment, and I fail to see how it promotes the avowed objective of voluntary compliance as enunciated by the Commissioner in sec. 5 quoted above.

COHEN, *J.*, agrees with this dissent.

ESTATE OF CLAIRE M. BALLARD, DECEASED, SHIRLEY A. WEBSTER, EXECUTOR, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 32658–83. Filed August 20, 1985.

Decedent, a U.S. citizen and domiciliary, died owning real property in Canada. Petitioner-estate paid tax to Canada pursuant to the Canadian Income Tax Act of 1971, ch. 63, Can. Stat. (1970–71–72), as amended. The tax paid to Canada was computed on the difference between the value of the real property on the date of death and the value of the property on Jan. 1, 1972, the date the relevant provisions of the Canada Income Tax Act became effective. *Held*, the tax paid to Canada is not an estate tax for which a credit is allowable under sec. 2014(a), I.R.C. 1954. *Held, further*, the Canadian tax paid is not a tax of substantially similar character to the estate tax that was imposed by Canada at the time the United States-Canada Estate Tax Convention, Feb. 17, 1961, 13 U.S.T. 382, T.I.A.S. No. 4995, was adopted and, therefore, it is not a creditable tax pursuant to the Convention.

G. Stephen Walters and *Shirley A. Webster*, for the petitioner.

Bruce W. Baker, for the respondent.

OPINION

DAWSON, *Judge*: Respondent determined a deficiency in petitioner's Federal estate tax in the amount of $17,931. Two issues are presented for decision: (1) Whether the tax paid by petitioner to Canada is an estate tax for which a credit is allowable under section 2014(a);[1] and (2) whether the tax paid by petitioner to Canada is a tax of substantially similar character to the estate tax imposed by Canada at the time the United States-Canada Estate Tax Convention, Feb. 17, 1961, 13 U.S.T. 382, T.I.A.S. No. 4995, was adopted, and, therefore, is a creditable tax pursuant to the Convention.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect at the time of Claire M. Ballard's death on Feb. 25, 1980, unless otherwise indicated.

This case was submitted fully stipulated pursuant to Rule 122, Tax Court Rules of Practice and Procedure. The stipulation of facts and the attached exhibits are incorporated herein by this reference. The pertinent facts are summarized below.

Claire M. Ballard (decedent) died on February 25, 1980. He was a U.S. citizen, domiciled in and a resident of Madison County, Iowa, at the time of his death. Shirley A. Webster was appointed executor of decedent's estate. At the time the petition was filed, Shirley A. Webster was a resident of Winterset, Iowa.

At the time of his death, decedent owned land in Stettler County, Alberta, Canada (Alberta property). The Alberta property had been owned by decedent for more than 20 years. The land was rented through decedent's agent primarily on a crop share basis to approximately a dozen different tenants. Decedent did not take an active part in the rental of the Alberta property.

Pursuant to the applicable Canadian tax statute, Revenue Canada originally assessed decedent's estate the sum of Can$404,586.75 (Canadian dollars) in tax on Canadian property owned by the decedent on the date of his death. The Canadian property included the Alberta property as well as mineral rights owned by the decedent on the Alberta property on the date of his death.

The Can$404,586.75 Canadian tax assessment was computed on the difference between the value of decedent's Canadian property on the date of his death and the value of such property as of January 1, 1972. For Canadian tax purposes, decedent's Alberta property had a value of Can$1,455,000 on the date of his death and an adjusted cost base[2] of Can$313,550. Under Canadian law, one-half, or Can$570,725, of the resulting gain of Can$1,141,450 was taxable. In addition, under Canadian law, the mineral rights on the Alberta property had a taxable gain of Can$69,619. The total taxable gain was subject to Canada's graduated income tax rates for individuals, resulting in a total Canadian tax of Can$404,586.75, which petitioner paid to Revenue Canada in November 1980.

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[2] Adjusted cost base is analogous to the U.S. concept of adjusted basis. See secs. 53 and 54(a), Canadian Income Tax Act of 1971, ch. 63, Can. Stat. (1970-71-72), as amended.

On November 24, 1980, respondent received petitioner's Federal estate tax return on which petitioner claimed a foreign death tax credit based upon the total Canadian tax paid to Canada. Respondent disallowed the credit and instead allowed petitioner a deduction under section 2053 for the Canadian tax paid.

Petitioner subsequently filed a protest with Revenue Canada, contending that decedent did not maintain a permanent establishment in Canada and that article VIII of the United States-Canada Income Tax Convention, Mar. 4, 1942, 56 Stat. 1399, T.S. No. 983, as supplemented (Income Tax Convention), exempts from Canadian income tax gains from the sales or exchanges of capital assets where a U.S. resident has no permanent establishment in Canada. Consequently, petitioner requested a full refund of the previously paid Canadian taxes. Although Revenue Canada agreed that decedent did not maintain a permanent establishment in Canada, it concluded that article VIII of the Income Tax Convention was not applicable. Revenue Canada found that the term "sale or exchange" of capital assets, as used in article VIII, does not include deemed dispositions of property resulting from the owner's death. Instead, Revenue Canada applied article XI of the Income Tax Convention, which subjects individuals to a reduced rate of 15 percent with respect to income other than earned income from sources within Canada. In February 1983, Revenue Canada refunded to petitioner Can$302,020.50. As a result of the refund, respondent disallowed a portion of the previously allowed section 2053 deduction and determined additional Federal estate tax, which petitioner paid.

Petitioner filed a claim for refund with the Internal Revenue Service in August 1983, seeking a refund of Can$17,135 in estate tax. The claim was based upon respondent's disallowance of the credit for foreign death taxes originally claimed on petitioner's estate tax return. Respondent sent to petitioner a notice of deficiency dated September 6, 1983. The notice of deficiency disallowed the previously allowed section 2053 deduction of $101,304 for Canadian tax paid, pending the final resolution of any appeal by petitioner of Revenue Canada's determination, which was confirmed by the Minister of National Revenue.

The period for filing an appeal of Revenue Canada's determination expired without an appeal being filed. As a result of the expiration of this period, respondent conceded in his answer that petitioner is entitled to a deduction of $101,304 for Canadian tax paid and, hence, that there is no deficiency in estate tax. Respondent disputes, however, that petitioner is entitled to a credit for the tax paid to Canada and, therefore, that an overpayment exists. Thus the issues remaining for decision pertain only to petitioner's claim that it is entitled to a credit for the foreign taxes paid.

Issue (1) Section 2014(a)

The parties disagree as to whether the tax imposed by Canada is an estate tax within the meaning of section 2014(a).[3] Respondent's position is set forth in Rev. Rul. 82-82, 1982-1 C.B. 127. Section 2014 provides, in part, as follows:

> SEC. 2014. CREDIT FOR FOREIGN DEATH TAXES.
>
> (a) IN GENERAL.—The tax imposed by section 2001 shall be credited with the amount of any estate, inheritance, legacy, or succession taxes actually paid to any foreign country in respect of any property situated within such foreign country and included in the gross estate * * *

In *Biddle v. Commissioner*, 302 U.S. 573 (1938), one issue was whether certain amounts paid by the taxpayers to the United Kingdom were foreign income taxes and therefore eligible to be used by the taxpayers as a foreign tax credit against their Federal income taxes. The Supreme Court held that this issue must ultimately be determined under U.S. tax concepts and not by reference to foreign tax concepts. The Court stated as follows:

> At the outset it is to be observed that decision must turn on the precise meaning of the words in the statute which grants to the citizen taxpayer a credit for foreign "income taxes paid." The power to tax and to grant the credit resides in Congress, and it is the will of Congress which controls the

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[3] Petitioner does not contend that the Canadian tax is an "inheritance, legacy, or succession" tax for which a credit is allowed under sec. 2014(a). Petitioner has either conceded this issue or has failed to meet its burden of proof. Rule 142(a), Tax Court Rules of Practice and Procedure.

> application of the provisions for credit. The expression of its will in legislation must be taken to conform to its own criteria unless the statute, by express language or necessary implication, makes the meaning of the phrase "paid or accrued," and hence the operation of the statute in which it occurs, depend upon its characterization by the foreign statutes and by decisions under them.
>
> Section 131 [of the Revenue Act of 1928, which allowed a foreign income tax credit] does not say that the meaning of its words is to be determined by foreign taxing statutes and decisions, and there is nothing in its language to suggest that in allowing the credit for foreign tax payments, a shifting standard was adopted by reference to foreign characterizations and classifications of tax legislation. The phrase "income taxes paid," as used in our own revenue laws, has for most practical purposes a well understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes. It is that meaning which must be attributed to it as used in § 131.
>
> [302 U.S. at 578–579; citations omitted.]

In the income tax area, in cases decided after *Biddle*, this Court and others have held that in order for a tax paid to a foreign government to be creditable under section 901, it must be the "substantial equivalent of an 'income tax' as the term is understood in the United States." See, e.g., *Commissioner v. American Metal Co.*, 221 F.2d 134, 137 (2d Cir. 1955), affg. 19 T.C. 879 (1953), and cases cited therein.

We have previously applied these principles of statutory construction, as enunciated by the Supreme Court in *Biddle*, outside of the foreign income tax credit area to decide whether the United Kingdom rates tax is a deductible foreign real property tax within the meaning of section 164(a)(1). *Waxenberg v. Commissioner*, 62 T.C. 594, 601–602 (1974). And we think that these principles are equally applicable here, in the estate tax area, in order to determine whether the taxes paid to Canada are "estate taxes." The credit provided for in section 2014(a) is for estate taxes paid to a foreign country. Congress did not express any intent in section 2014 that the foreign tax be examined under foreign law. Consequently, we must examine it under the concepts of U.S. law. Thus, in order for the tax here to qualify for the section 2014 credit, we think it must be the substantial equivalent of an "estate tax" as the term is understood in the United States.

The nature and character of an estate tax is that of an excise tax upon the privilege of transferring property of the decedent at death. *Knowlton v. Moore*, 178 U.S. 41, 56 (1900). See

Reinecke v. Northern Trust Co., 278 U.S. 339, 349 (1929). In *Knowlton v. Moore, supra*, the Supreme Court traced the history of death duties and concluded as follows:

> Although different modes of assessing such duties prevail, and although they have different accidental names, such as probate duties, stamp duties, taxes on the transaction, or the act of passing of an estate or a succession, legacy taxes, estate taxes or privilege taxes, nevertheless tax laws of this nature in all countries rest in their essence upon the principle that death is the generating source from which the particular taxing power takes its being and that it is the power to transmit, or the transmission from the dead to the living, on which such taxes are more immediately rested. [178 U.S. at 56.]

As understood in the United States,

> The estate tax is an excise tax on the transfer of property occasioned by death. The measure of the tax is the net estate of the decedent, which is the value of the gross estate less certain statutory deductions. * * * [*Kleberg v. Commissioner*, 31 B.T.A. 95, 100 (1934).]

An examination of the Canadian statute involved in this case reveals that the Canadian tax is not the substantial equivalent of an "estate tax" as the term is understood in the United States.

Under section 70(5)(a) of the Canadian Income Tax Act, ch. 63, Can. Stat. (1970–71–72), as amended (Income Tax Act), in effect at the time of decedent's death, a decedent who died owning capital property located in Canada on the date of his death,

> Shall be deemed to have disposed, immediately before his death, of each property owned by him at that time that was a capital property of the taxpayer * * * and to have received proceeds of disposition therefor equal to the fair market value of the property at that time * * *

"Capital property" is defined under section 54(b) of the Income Tax Act as follows:

> (b) "*Capital property*."—"capital property" of a taxpayer means
> (i) any depreciable property of the taxpayer, and
> (ii) any property (other than depreciable property), any gain or loss from the disposition of which would, if the property were disposed of, be a capital gain or a capital loss, as the case may be, of the taxpayer * * *

Sections 38, 39, and 40 of the Income Tax Act provide definitions for capital gains and losses and general rules with respect to the determination of the amount of a taxpayer's taxable gain or loss. In general, the amount of the capital gain or loss is the difference between the proceeds from disposition of the property (or fair market value of the property in the case of a deemed disposition) less the adjusted cost base of the property. Secs. 40(1) and 70(5) of the Income Tax Act. Taxable capital gain is one-half of capital gains, and allowable capital loss is one-half of capital losses, as computed above. Sec. 38 of the Income Tax Act. The difference between taxable capital gain and allowable capital loss is added to income or deducted (up to $2,000), as the case may be. Sec. 3 of the Income Tax Act.

Where nondepreciable capital property is owned by a decedent-taxpayer on December 31, 1971, the adjusted cost base of the property is determined by reference to the fair market value of the property on December 31, 1971, the date after which the Income Tax Act generally became effective. Secs. 24 to 26, Income Tax Application Rules, 1971. In general, the net effect is that a decedent is taxed only on gain accruing since December 31, 1971, and only to the extent that the gain exceeds the original cost of the property. Similarly, losses are deductible only to the extent that they have accrued after December 31, 1971, and only if they are losses compared with actual cost.

The tax imposed by Canada is not on the transfer of property nor on the power to transfer property at death. This is evidenced by the measure of the tax, which is on *gain, if any exists*. In this case, the decedent died owning the Alberta property valued at Can$1,455,000. The accrued gain on the property for Canadian tax purposes was Can$1,141,450, after subtracting the adjusted cost base of Can$313,550. Had decedent's total adjusted cost base equaled or exceeded the fair market value of the Alberta property, no tax would have been imposed. Section 70(5) of the Income Tax Act includes a provision creating a deemed disposition that may result in a taxable gain or a deductible loss. The deemed disposition is unrelated to, and independent of, the fact that property with value of the decedent is transmitted to a beneficiary. The focus of the relevant provisions of the Income Tax Act is the recognition of gain or loss, not the taxation of the transmission of property from the dead to the living. The tax paid to Canada in the instant case is not, therefore, the substantial equivalent of an estate tax, as understood in the United States. We hold for respondent on this issue.

Petitioner contends that because the Canadian statute provides that the death of a taxpayer is the basis for assessing the tax, the tax must be an estate tax. We disagree. As previously stated, in order to be creditable, the tax must be the substantial equivalent of an "estate tax" as the term is understood in the United States. It is not enough that death is the triggering event for assessing the tax. In the Income Tax Act, death is merely the event that creates the deemed disposition and is the time at which the gain or loss is recognized for Canadian tax purposes.

Petitioners also argues that because section 2014 was enacted to prevent double taxation, the Canadian tax paid should be creditable. While it may be true that the enactment was intended to prevent double taxation, the possibility that denial of the credit may result in double taxation is not a sufficient basis for granting the credit where there is no compliance with the specific requirements of the provision granting such benefit. Allowance of a credit for foreign taxes is a privilege and the statute must be strictly construed. *Federated Mutual Implement & Hard. Ins. Co. v. Commissioner*, 266 F.2d 66, 72 (8th Cir. 1959), affg. 29 T.C. 262 (1957) (concerning the computation of the taxpayer's allowable foreign income tax credit); *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894, 898 (3d Cir. 1943) (holding that the tax imposed by the Quebec Mining Act is not a creditable foreign income tax).

Issue (2) Estate Tax Convention

Petitioner contends that the Canadian tax paid should be creditable under the provisions of the United States-Canada Estate Tax Convention, Feb. 17, 1961, 13 U.S.T. 382, T.I.A.S. No. 4995 (Estate Tax Convention), in effect at the time of decedent's death. Specifically, article V of the Estate Tax Convention provides, in part, as follows:

> 1. Where either contracting State imposes tax by reason of a decedent being domiciled therein or being a citizen thereof, that contracting State shall allow against so much of its tax (as otherwise computed) as is attributable to property situated in the other contracting State a credit (not exceeding the amount of the tax so attributable) equal to so much of the tax imposed by the other contracting State as is attributable to such property.

Respondent contends that the Canadian tax in question here is not covered by the Estate Tax Convention. We agree with respondent.

Effective April 9, 1962, the Estate Tax Convention, as stated in its preamble, was enacted for the principal purposes of "the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on the estates of deceased persons." Article I of the Estate Tax Convention specifies the taxes that are covered by the convention as follows:

> 1. The taxes referred to in this Convention are:
>
> (a) for the United States of America: the Federal estate tax;
>
> (b) for Canada: the estate tax imposed by the Government of Canada.
>
> 2. The present Convention shall also apply to any other taxes of a substantially similar character imposed by either contracting State subsequent to the date of signature of the present Convention.

Section 34 of the Canadian Estate Tax Act, ch. 29, Can. Stat. (1958), as amended (Estate Tax Act),[4] in existence in Canada at the time the Estate Tax Convention came into force, provided for the imposition of an estate tax in respect of persons domiciled outside of Canada as follows:

> (1) In the case of the death, at any time after the coming into force of this Act, of any person domiciled outside Canada at the time of his death, an estate tax shall be paid as hereinafter required upon the aggregate value of all taxable property (hereinafter in this Part referred to as the "property taxable on the death"), being property situated in Canada at the time of his death, the value of which would, if that person had been domiciled in Canada at the time of his death, be required by this Act to be included in computing the aggregate net value of the property passing on his death.
>
> (2) The tax payable under this Part upon the aggregate value of the property taxable on the death of any person is the tax payable as fixed by assessment or re-assessment subject to variation on objection or appeal, if any, in accordance with the provisions of Part I.

It is clear that the tax imposed under section 34 of the Estate Tax Act was an estate tax as that term is known and understood in the United States. The tax was imposed on the "aggregate value of all taxable property" situated in Canada and was similar to the U.S. estate tax. In contrast, the tax imposed under section 70(5) of the Income Tax Act in issue in the present case is a tax based on the net gain (if any) resulting from the deemed disposition of property owned by a decedent-taxpayer immediately before death. The imposition of the tax under section 70(5) of the Income Tax Act is triggered by the existence of gain, not the existence of value, as is the case with an estate tax such as the tax imposed under section 34 of the Estate Tax Act. For these reasons and for the reasons previously stated in the discussion of issue (1), the Canadian tax in issue herein is not an estate tax; consequently, it is not a tax of a "substantially similar character" to the repealed Canadian estate tax so as to be eligible for the credit under the Estate Tax Convention.

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[4] The Canadian statute in question in the instant case, pursuant to which petitioner paid tax to Canada, was not part of the Estate Tax Act. As part of major tax reform legislation, Canada repealed its estate tax laws with respect to decedents dying after Dec. 31, 1971. The statute in question in the instant case was enacted as part of this tax reform.

The only similarity between the income tax imposed by the Income Tax Act in the instant case and the tax eligible for the credit under the Estate Tax Convention is that both taxes may arise upon the death of a taxpayer. This fact alone does not make the tax imposed by the Income Tax Act "substantially similar" to an estate tax since it is outweighed by the lack of fundamental characteristics of an estate tax. Accordingly, we hold for respondent on this issue.

To reflect respondent's concession and our conclusions with respect to the disputed issues,

Decision of no deficiency and no overpayment will be entered.

EVERETT J. GORDON AND MARIAN K. GORDON, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 28805–82. Filed August 20, 1985.

Petitioner husband and petitioner wife, the latter as trustee of a trust established by petitioner husband for the benefit of petitioners' children, entered into joint purchase agreements whereby, in form, petitioner husband purchased income interests for life, and the trust purchased remainder interests, in certain bonds. Petitioner husband entered into a similar agreement with himself as trustee of a pension trust for the benefit of his employees. *Held*, because, in substance, petitioner husband

purchased the bonds in their entirety, petitioners' amortization deductions for the cost of the income interests purportedly purchased by petitioner husband were properly disallowed.

Louis H. Diamond, Wayne K. Johnson, William S. Oshinsky, and *Peter Lipresti,* for the petitioners.

Carolyn A. Boyer, for the respondent.

TANNENWALD, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes for taxable years 1976, 1977, and 1978 of $4,852, $7,903, and $17,296.50, respectively. After concessions by both parties concerning petitioners' distributive share of certain partnership losses, the sole issue for decision is whether respondent properly denied petitioners' amortization deductions with respect to the purported acquisition by petitioner Everett J. Gordon (Dr. Gordon) of income interests in municipal bonds purchased pursuant to joint purchase agreements entered into by Dr. Gordon and certain trusts.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. This reference incorporates the stipulation of facts and attached exhibits. At the time they filed their petition in this case, petitioners resided in Deerfield Beach, Florida. Petitioners filed joint Federal income tax returns for 1976, 1977, and 1978.

Dr. Gordon was born on July 23, 1914. Petitioner Marian K. Gordon (Mrs. Gordon) was born on November 23, 1926. On October 3, 1960, Dr. Gordon executed an agreement that established a trust for the benefit of petitioners' only three children—Solvin W., Stuart L., and Elissa A. Gordon. The agreement named David S. Gordon, Dr. Gordon's brother, as trustee, and provided for termination of the trust and reversion to Dr. Gordon as grantor on November 30, 1970.

On April 19, 1972, after termination of the October 3, 1960, trust, Dr. Gordon, as settlor, and Mrs. Gordon, as trustee, executed an agreement establishing an irrevocable trust (the family trust) to succeed the October 3, 1960, trust. The trust agreement grants to the trustee "full and complete power in the management and control of the Trust property," but the trustee is given no power "to purchase, exchange, or otherwise deal with or dispose of all or any part of the corpus or income of the Trust for less than an adequate consideration in money or money's worth." The agreement specifies a successor trustee in the event Mrs. Gordon fails or ceases to serve, and provides that "In no event shall the grantor of any funds to this Trust be a TRUSTEE hereunder." Stating that the family trust was created "with the purpose and intent permanently and absolutely to divest the SETTLOR of any and all beneficial interest in and over all possession, dominion, and control of the said property," the trust agreement provides that it shall not be construed "as authorizing or empowering the SETTLOR, either with or without action of the TRUSTEE, to reinvest themselves [sic], expressly or by operation of law, of the beneficial title to all or any part of the Trust property or its revenue." The settlor is given "no power, either alone or in conjunction with any other person or persons, * * * to alter, amend, modify, revoke, or terminate this instrument in any way except to make additions to the corpus."

By letter dated November 28, 1972, Louis H. Diamond and Wayne K. Johnson, both of the law firm of Danzansky, Dickey, Tydings, Quint & Gordon, advised Dr. Gordon as follows:

Everett J. Gordon, M.D.
President
EVERETT J. GORDON, M.D., CHARTERED
9401 Indian Head Highway
Oxon Hill, Maryland 20022

Dear Everett:

As we discussed with you on November 1, 1972, we believe that it is possible to develop a format for acquisition of an interest in income-producing property that will provide to an investor a substantial tax-free cash flow during his life, a proportionate tax deduction over his life expectancy of his cost of acquisition, and a reduction of his taxable estate. This arrangement is very well adapted to use by an incorporated professional with a qualified pension or profit sharing trust. The essence of the transaction is a joint purchase by the professional and the qualified trust of, respectively, a life or income interest, and a remainder interest in a portfolio of tax exempt state or municipal bonds.

Under such an arrangement, the professional would purchase at fair value a life estate in the bond portfolio and the trust would purchase the remainder interest. Assuming a bond portfolio of $100,000, for example, and a male professional, age 55, the Life Tenant's cost would be approximately $61,780, and the cost to the qualified trust would be approximately $38,220.

Assuming a 5 percent bond coupon, the Life Tenant's income would be $5,000 per year. The Life Tenant would also be entitled to deduct $6,000 per year as depreciation on his purchase life interest until he had fully recovered $61,780. If the professional lived beyond the actuarial assumption of 10.3 years, the $5,000 per year would still be received as tax-free interest, but there would be no more further depreciation deductions. To protect the trust and assure that its return on its investment would not fall below a 4 percent compounded rate, however, we would recommend that the terms of the agreement provide that the Life Tenant's interest is to terminate, in any event, after 25 years from date of execution of the agreement. If the Life Tenant were to die before the assumed 10.3 years, a loss deduction would be allowed for the amount of his unrecovered basis.

The tax advantages of this arrangement for the Life Tenant may be summarized as follows:

1. The interest received each year by the Life Tenant is exempt from federal income tax. The joint purchase agreement would be prepared to create a legal life estate in the Life Tenant. The interest received by the Life Tenant, like that received by the income beneficiary of a trust, will be entitled to tax exemption.

2. The Life Tenant receives each year the benefit of a deduction of a proportionate part of the cost of his interest. The Internal Revenue Service recognizes the cost of a purchased life estate as a depreciable asset with a useful life equal to the life expectancy of the Life Tenant. See Rev. Rul. 62-132, 1962-2 C.B. 72. In our opinion, a depreciation deduction will be allowed for such cost even though the income received by the Life Tenant is tax exempt. *Manufacturers Hanover Trust Co. v. Commissioner*, 431 F.2d 634 (2d Cir. 1970).

3. At the death of the Life Tenant, no portion of the bond portfolio will be included in his gross estate.

The qualified trust as remainderman is not subject to income tax and would derive no advantage from the receipt of tax exempt interest. Upon termination of the Life Tenant's interest, the logical step would therefore be for the qualified trust to sell the property and to invest the proceeds in higher yielding securities or other investments.

If you are interested in pursuing this matter, we would be glad to prepare the necessary documents for execution by you and by the qualified trust.

Best regards.

Sincerely,

LOUIS H. DIAMOND

(S)Wayne K. Johnson
WAYNE K. JOHNSON
(For the Firm)

As of May 26, 1972, the value of the corpus of the family trust, consisting of common stock holdings, was $45,261.38. In early 1973, Dr. Gordon contemplated implementing the transaction detailed in the letter, and, because there was at that time either no or insufficient cash in the family trust, Dr. Gordon turned to the Everett J. Gordon, Chartered Pension Trust (the pension trust) as his investment vehicle. Dr. Gordon never contemplated either selling the stock holdings of the family trust to buy the bonds or engaging in the transaction with an outside party. The pension trust had been established in 1969 for the benefit of Dr. Gordon's employees.[1] On January 22, 1973, Mr. Johnson wrote to Harvey R. Hale, an investment adviser at Ferris & Co., the investment firm used by petitioners from 1949, reflecting Dr. Gordon's intention to purchase $100,000 in bonds under a joint purchase agreement with the pension trust. Mr. Hale, by letter of February 2, 1973, recommended bonds for purchase to Mr. Johnson; aside from such recommendations of specific bonds, Ferris & Co. had nothing to do with the development of the investment strategy at issue herein.

On February 12, 1973, Dr. Gordon, individually, entered into a joint purchase agreement with himself as trustee of the pension trust providing as follows:

JOINT PURCHASE AGREEMENT

For their mutual economic advantage, the undersigned, EVERETT J. GORDON, M.D. ("Life Tenant"), and EVERETT J. GORDON, M.D., CHARTERED, MONEY-PURCHASE PENSION TRUST ("Remainderman"), agree to contribute in proportion to their actuarial interests the amounts necessary to purchase municipal bonds in the principal amount of ONE HUNDRED THOUSAND ($100,000.00) DOLLARS ("the Corpus") from FERRIS & COMPANY, INCORPORATED, at a total price not to exceed ONE HUNDRED TEN THOUSAND ($110,000.00) DOLLARS. The contribution percentages of each of the parties are specified above their signatures at the foot of this Agreement.

It is agreed by and between the parties that the Life Tenant shall be entitled to receive the full benefit of any income derived from the Corpus purchased under this Agreement from the later of the date of its acquisition or the date of this Agreement, until the earlier of the day preceding the date of his death or the twenty-fifth (25th) anniversary of the execution of this Agreement. The Life Tenant shall, correspondingly, bear all expenses attributable to his interest in the Corpus. The entitlements and the obligations of the parties shall be determined in accordance with the Revised Uniform Principal and Income Act (Ann. Code of Maryland, Art. 75B §12).

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[1] The trust agreement as to the pension trust does not appear in the record. The pension *plan*, which refers to a "related trust," appears as Exhibit 98-CT.

Upon the death of the Life Tenant, all of his right, title and interest shall pass to and immediately vest in the Remainderman. The Remainderman shall thereupon be entitled to take title to the Corpus in its own name and to hold, manage, and deal with the property as its own without restriction.

During the term of this Agreement, title to any property acquired as Corpus shall be taken in the name of

Everett J. Gordon, M.D.,
as Life Tenant under Joint
Purchase Agreement of
February 12, 1973.

Executed in triplicate this 12th day of February, 1973.

EVERETT J. GORDON, M.D.
(Life Tenant)
Contribution percentage: 57.778

(S) Everett J. Gordon, M.D.
Everett J. Gordon, M.D.

as to Everett J.
Gordon, M.D.

EVERETT J. GORDON, M.D.,
CHARTERED, PENSION TRUST
(Remainderman)
Contribution percentage: 42:222

(S) Everett J. Gordon, M.D., Trustee
Everett J. Gordon, M.D., Trustee

as to Everett J.
Gordon, M.D.,
Trustee

The percentages were taken from section 20.2031–10(f), table A(1), Estate Tax Regs.[2]

Pursuant to this agreement, the following bonds were purchased:

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[2] We note that the regulation actually requires use of the "age" in Table A(1) "nearest to the actual age" of the measuring life. Sec. 20.2031–10(d), Estate Tax Regs. Thus, the proper factor for Dr. Gordon, who reached 58 on July 23, 1972, would appear to be .56417. Respondent, however, does not challenge the percentages used by petitioner; consequently, for purposes of this proceeding, we will assume that they are correct.

Bonds	*Cost*[3]	*Remainder portion*	*Life portion*
Los Angeles Dept. of Water & Power, 5.2 percent, maturity 1-1-10			
Maryland Bridge & Tunnel Revenue, 5.2 percent, maturity 10-1-08	$76,366.12	$31,771.00	$44,595.12
New York Port of New York, 5.375 percent maturity 11-1-06			
Nebraska Omaha Public Power District, 5.375 percent, maturity 2-1-06	25,241.46	10,608.59	14,632.87

The statement of account by Ferris & Co. for "Everett J. Gordon MD—Life Tenant Under Jt Purchase Agreement of 2-12-73" reflects credits for each of the four components of cost shown above. Dr. Gordon and the pension trust issued checks to Ferris & Co. for the amounts representing the portions of the cost allocable to the income and remainder interests, respectively.

A savings account for the family trust was opened on July 9, 1974, at National Permanent Federal Savings & Loan Association (National Permanent) with a deposit representing funds transferred from an individual account in Mrs. Gordon's name at National Permanent. Thereafter, cash deposits were made to the family trust account of investment income of the children's various trusts, family trust investment income, and funds derived from Dr. Gordon. The latter constituted checks payable to Dr. Gordon and deposited by Mrs. Gordon in the family trust account when she concluded that the funds were not needed for family purposes. The amounts of these checks are attributable to Dr. Gordon.

On July 10, 1974, Dr. Gordon and Mrs. Gordon, as trustee of the family trust, entered into a joint purchase agreement identical to the February 12, 1973, agreement with the pension trust except that there was no 25-year limit on Dr. Gordon's income interest, the bonds were to be in the principal amount of $25,000, and the contribution percentages for Dr. and Mrs. Gordon were, pursuant to section 20.2031–10(f), table A(1), Estate Tax Regs., 56.417 percent and 43.583 percent, respectively. Pursuant to this agreement, the following bonds were purchased—

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[3] The "cost" figures stipulated to by the parties appear to include accrued interest, which was paid by the "life tenant." Thus, Dr. Gordon, individually, was to pay 57.778 percent of the principal amount of the bonds plus all of the accrued interest thereon. This calculation method was used for all of the bond purchases at issue herein.

Bonds	*Cost*	*Remainder portion*	*Life portion*
Pennsylvania State Highway, 6.6 percent, maturity 12–15–97	$25,114.58	$10,943.69	$14,170.89

Payment of these bonds was reflected by a single credit on the Ferris & Co. statement of account, rather than in the manner of every other joint purchase transaction at issue herein, i.e., two separate credits—one for the portion allocable to the remainder interest and the other for the portion allocable to the income interest. The bond purchase pursuant to this agreement was completed by the end of July 1974.[4]

During 1974, a total of $14,503.07 was deposited into the savings account, excluding interest. The only withdrawals from the family trust's savings account in 1974 were in the amounts of $8,340.29, on July 9, and $4,993.38, on October 3. During 1975, $6,458.62 was deposited into the family trust's account, excluding interest, and $3,821.72 was withdrawn.

On July 16, 1976, Dr. Gordon and Mrs. Gordon, as trustee of the family trust, entered into a joint purchase agreement identical to the July 10, 1974, agreement, except that the bonds were to be in the principal amount of $100,000, and the contribution percentages for Dr. and Mrs. Gordon were, pursuant to section 20.2031–10(f), table A(1), Estate Tax Regs., 52.321 percent and 47.679 percent, respectively. Pursuant to this agreement, the following bonds were purchased—

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[4] The record contains no checks reflecting payment for either of the allocable interests. It is clear that the family trust had insufficient cash funds to pay for its allocable share of the total cost. We think it reasonable, then, to infer that Dr. Gordon paid personally for the entire cost of the bonds. At least petitioners, who have the burden of proof (see Rule 142(a), Tax Court Rules of Practice and Procedure), have not shown otherwise.

Bonds	*Cost*	*Remainder portion*	*Life portion*
St. Paul, Minnesota, 6.0 percent maturity 2-1-93	$24,875.33	$11,860.31	$13,015.02
San Antonio, Texas, 6.0 percent, maturity 2-1-94	24,803.58	11,826.10	12,977.48
Colorado Springs Utilities, 6.2 percent maturity 11-15-98	25,094.72	11,964.91	13,129.81
Nebraska Public Power Electric, 6.25 percent, maturity 1-1-91	25,043.40	11,940.44	13,102.96

Dr. Gordon issued checks on his office account to Ferris & Co. for the amounts representing the portion of the cost allocable to the income interests. The amounts representing the portion of the cost allocable to the remainder interests were paid by bank checks payable to Mrs. Gordon, as trustee, for withdrawal of funds from the Family Trust's savings account, and endorsed to Ferris & Co. On the Ferris & Co. statement of account, the amounts representing the portions of the cost of the July 16, 1976, purchases allocable to the income interests and the remainder interests were credited separately but identified merely as "DEP CAPITAL ADDITION."

During 1976, a total of $95,043.94, excluding interest and a refund from Ferris & Co. of an overpayment, was deposited in the family trust's account. This amount included three cash gifts to the family trust by Dr. Gordon totaling $32,775, which amount was shown on petitioners' gift tax returns as gifts directly to petitioners' three children for the quarter ending September 30, 1976. The maximum amount available for deposit into the family trust account during 1976 attributable to family trust investments and the various trust interests of petitioners' three children was $16,903.30. The remaining $45,365.64, attributable to Dr. Gordon (see *supra* p. 315), was not reported on gift tax returns filed by petitioners for 1976. Also during 1976, other than a $3,727.95 withdrawal from the family trust's account on February 6, all the withdrawals from the account were for the 1976 bond purchases. After the bond purchases pursuant to the July 16, 1976, agreement were completed, the balance of the family trust's account was $1,332.81.

On January 31, 1977, Dr. Gordon and Mrs. Gordon, as trustee of the family trust, entered into a joint purchase agreement identical to that of July 16, 1976, except that the contribution percentages for Dr. and Mrs. Gordon were, pursuant to section 20.2031–10(f), table A(1), Estate Tax Regs., 50.954 percent and 49.046 percent, respectively. Pursuant to this agreement, the following bonds were purchased—

Bonds	*Cost*	*Remainder portion*	*Life portion*
Baltimore County, 5.4 percent, maturity 4–1–97	$24,912.00	$12,218.34	$12,693.66
Memphis, Tennessee, 5.2 percent, maturity 5–1–94	25,050.56	12,286.30	12,764.26
Washington Sub. San. Comm., 5.25 percent, maturity 2–1–95	24,684.52	12,106.77	12,577.75
Omaha Pub. Pwr. District, 5.7 percent, maturity 2–1–95	25,153.54	12,336.81	12,816.73

Dr. Gordon issued checks on his office account to Ferris & Co. for the amounts representing the portion of the cost allocable to the income interests. The amounts representing the portion of the cost allocable to the remainder interests were paid by bank checks payable to Mrs. Gordon, as trustee, for withdrawal of funds from the family trust's savings account and endorsed to Ferris & Co. On the Ferris & Co. statement of account, the amounts representing payment for the portions of the cost of the January 31, 1977, purchases allocable to the income interests and the remainder interests were credited separately but identified merely as "DEP CAPITAL ADDITION." After these bond purchases were completed, the balance of the family trust's savings account was $3,066.44.

On July 7, 1977, Dr. Gordon and Mrs. Gordon, as trustee of the family trust, entered into a joint purchase agreement identical to that of January 31, 1977. Pursuant to this agreement, the following bonds were purchased—

Bonds	*Cost*	*Remainder portion*	*Life portion*
Pennsylvania Commonwealth, 5.5 percent, maturity 2-1-97	$24,337.93	$11,936.78	$12,401.15
Virginia Hampton Rds. Sanit., 5.8 percent, maturity 7-1-05	25,108.75	12,314.84	12,793.91
Washington Pub. Pwr. Supply, 5.7 percent, maturity 7-1-09	25,106.88	12,313.92	12,792.96
Pennsylvania Allegheny Co., 5.7 percent, maturity 8-1-07	25,158.34	12,339.16	12,819.18

Dr. Gordon issued checks on his office account to Ferris & Co. for the amounts representing the portion of the cost allocable to the income interests. The amounts representing the portion of the cost allocable to the remainder interests were paid by bank checks payable to Mrs. Gordon, as trustee, for withdrawal of funds from the family trust's savings account and endorsed to Ferris & Co. On the Ferris & Co. statement of account, the amounts representing payment for the portions of the cost of the July 7, 1977, purchases allocable to the income interests and remainder interests appear as separate credits but were identified merely as "DEP CAPITAL ADDITION."

During 1977, excluding interest, a total of $78,458.89 was deposited in the family trust's savings account. Included were a total of $31,313.75 in checks, drawn on Dr. Gordon's office account and his professional corporation's office account, deposited directly into the family trust's savings account. The maximum amount available for deposit into this account during 1977 attributable to family trust investments and the various trust interests of petitioners' three children was

$20,359.15. The remaining $26,785.99, attributable to Dr. Gordon (see *supra* p. 10), as well as the $31,313.75 deposited by or on behalf of Dr. Gordon, was not reported on gift tax returns filed by petitioners during 1977. The only withdrawals in 1977 from the family trust savings account were for payments pursuant to the joint purchase agreements of January 31, 1977, and July 7, 1977. After completion of these purchases, the family trust's savings account balance was $1,055.67.

On February 3, 1978, Dr. Gordon and Mrs. Gordon, as trustee of the family trust, entered into a joint purchase agreement identical to those of January 31, 1977, and July 7, 1977. Pursuant to this agreement, the following bonds were purchased—

Bonds	*Cost*	*Remainder portion*	*Life portion*
Maryland State Comm. Dev. Adm., 6.5 percent, maturity 1-1-08	$20,021.67	$9,819.83	$10,201.84
Arizona Salt River Project, 6.2 percent, maturity 1-1-18	20,189.56	9,902.17	10,287.39
Louisville Water Rev., 6.0 percent, maturity 11-15-05	20,100.00	9,858.25	10,241.75
South Carolina Pub. Service Auth., 5.875 percent, maturity 7-1-18	19,432.64	9,530.93	9,901.71
Wash. Pub. Pwr. Supply, 6.8 percent, maturity 7-1-10	19,525.00	9,602.17	9,975.72

Dr. Gordon issued checks on his office account to Ferris & Co. for the amounts representing the portion of the cost allocable to the income interests. The amounts representing the portion of the cost allocable to the remainder interests were paid by bank checks payable to Mrs. Gordon, as trustee, for withdrawal of funds from the family trust's savings account and endorsed to Ferris & Co. On the Ferris & Co. statement of account, the amounts representing payment for the portions of the cost of the February 3, 1978, purchases allocable to the income interests and remainder interests were credited separately but identified merely as "DEP CAPITAL ADDITION."

During 1978, excluding interest, a total of $91,431.61 was deposited to the family trust savings account; $41,401.52 of this amount was deposited before the purchases pursuant to the February 3, 1978, agreement were completed. This amount included a deposit of cash amounts distributed to Mrs. Gordon pursuant to the settlement in 1978 of Mrs. Gordon's mother's estate. The maximum amount available for deposit to this account during 1978 attributable to family trust investments and the various trust interests of petitioners' three children was $35,045.23. The remaining $56,386.38 (including the distribution to Mrs. Gordon from her mother's estate), attributable to petitioners (see *supra* pp. 315–316), was not reported on gift tax returns filed by petitioners for 1978. Petitioners did report cash gifts directly to the children totaling $18,000. The only withdrawals during 1978 other than those pursuant to the purchase agreement dated February 3, 1978, were a $20,000 transfer to a 6-month certificate of deposit at National Permanent and a $3,250 check withdrawal. After completion of the bond purchases, the family trust's savings account balance was $3,846.44.

Mrs. Gordon received a degree in business administration from Ohio State University. Her decision to enter the joint purchase agreements was based on her perception that, based on Dr. Gordon's life expectancy, it was a good investment for the family trust to invest some 50 percent of the cost of the bonds in order to receive 100 percent of the proceeds on the death of Dr. Gordon, and that, even if Dr. Gordon outlived his life expectancy, he would then be around to provide financial assistance to the beneficiaries, i.e., the children, either directly or through augmentation of the family trust.[5] Beyond this, Mrs. Gordon did not consider present values or income yields for the investments. Mrs. Gordon also did not consider whether the excess of the family trust's bond proceeds over its cost bases would be taxed as capital gain or ordinary income.

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[5] The record contains no indication that Mrs. Gordon gave any consideration to the fact that Dr. Gordon might not be in a position to give such financial assistance if he became disabled and could no longer carry on his medical practice.

Petitioners claimed the following amortization deductions for "purchase—life estate":

Year	*Date acquired*	*Basis*	*Percentage*	*Depreciation*
1976	2/23/73	$58,904	.1090	$6,421
	7/ 8/74	14,169	.0945	1,339
	7/27/76	52,046	.0617	1,338
				9,098
1977	2/23/73	$58,904	.1090	6,421
	7/ 8/74	14,169	.0945	1,339
	7/27/76	52,046	.0617	3,211
				10,971
1978	2/23/73	$58,904	.1090	6,421
	7/ 6/74	14,169	.0945	1,339
	7/27/76	52,046	.0617	3,211
	7/25/77	50,456	.0707	3,567
	1/31/77	50.690	.0707	3,584
	2/ 3/78	50,954	.0678	3,167
				21,289

OPINION

At issue is the deductibility ratably over Dr. Gordon's expected life of his cost of acquiring his income interests in the bonds purchased pursuant to the joint purchase agreements. Petitioners argue that Dr. Gordon purchased his interests in bona fide transactions, and that such interests are wasting assets eligible for ratable deduction. Respondent's contention has two parts: (1) While, in form, the purchases were joint, in substance Dr. Gordon purchased the bonds in whole and donated the remainder interests to the trusts; thus, (2) petitioners' attempt to create an amortization deduction by splitting an existing nondepreciable asset must be rejected.

It is clear that a taxpayer may deduct ratably his or her cost basis in a *purchased* term, including a life, interest.[6] *Early v.*

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[6] There has been considerable controversy as to whether these ratable deductions are allowable as depreciation or amortization under sec. 167 or as amortization under secs. 162 and 212. See *Sohosky v. Commissioner*, 57 T.C. 403, 409 & n. 4 (1971), affd. 473 F.2d 810 (8th Cir. 1973); *Early v. Commissioner*, 52 T.C. 560, 568–572 (1969) (Tannenwald, J., dissenting). For purposes of discussion herein, we simply acknowledge that ratable deductions of some nature are allowable to a purchaser of a term interest in property either used in a trade or business or held for the

Commissioner, 445 F.2d 166, 169 (5th Cir. 1971), revg. on another ground 52 T.C. 560 (1969); *Manufacturers Hanover Trust Co. v. Commissioner*, 431 F.2d 664 (2d Cir. 1970), affg. a Memorandum Opinion of this Court; *Gist v. United States*, 296 F. Supp. 526, 528 (S.D. Cal. 1968), affd. 423 F.2d 1118 (9th Cir. 1970); *Frank MacBoyle Lewis Trust B v. Commissioner*, 83 T.C. 246, 253 n. 10 (1984); *Elrick v. Commissioner*, 56 T.C. 903, 909 (1971), revd. on another ground 485 F.2d 1049 (D.C. Cir. 1973); see also secs. 167(h), 62(6).[7] This is true even where the property underlying the purchased term interest is itself nondepreciable. See, e.g., *Early v. Commissioner, supra; Manufacturers Hanover Trust Co. v. Commissioner, supra; Elrick v. Commissioner, supra*. However, it is also clear that where a taxpayer, without additional investment, *divides nondepreciable property into two parts*, one of them being a term interest, amortization deductions are not allowable. *United States v. Georgia Railroad & Banking Co.*, 348 F.2d 278, 286–289 (5th Cir. 1965); *Lomas Santa Fe, Inc. v. Commissioner*, 74 T.C. 662, 681–684 (1980), affd. 693 F.2d 71 (9th Cir. 1982).

In *United States v. Georgia Railroad & Banking Co., supra*, the corporate taxpayer had "leased" certain of its stockholdings to an individual, and later distributed its reversionary interest therein to its shareholders as a dividend in kind. After holding that the leasehold that the taxpayer created in nondepreciable stock was itself not depreciable property, as the taxpayer incurred no additional costs in acquiring the leasehold, the Court of Appeals for the Fifth Circuit held that the dividend distribution of the reversion did not make the retained "lease" a depreciable asset. According to the court—

> By distributing the reversion in 1954, taxpayer did nothing more than split its bundle of property rights into two parts. We cannot see how this action on its part can result in a depreciable asset where none previously existed, unless it made some additional investment. * * * Depreciability cannot be conferred merely by the voluntary, gratuitous division of its nondepreciable property into two segments, one of which becomes, as a result of the

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production of income. For convenience, we have used the term "amortization" in discussing the transactions involved herein.

In this connection, we note that respondent, in his opening brief, dropped the argument that petitioners' deductions are not allowable due to sec. 265(1), which disallows deductions allocable to tax-exempt income. See *Manufacturers Hanover Trust Co. v. Commissioner*, 431 F.2d 664 (2d Cir. 1970), affg. a Memorandum Opinion of this Court.

[7] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

> separation, wasting solely by reason of lapse of time. [*United States v. Georgia Railroad & Banking Co., supra* at 288–289.]

Similarly, in *Lomas Santa Fe, Inc. v. Commissioner, supra*, the taxpayer owned land on which it planned to develop a luxury community, and, for business reasons relating to State law, formed a wholly owned subsidiary to hold the portion of the land designated for a golf course and country club, which the taxpayer transferred to the subsidiary subject to a retained estate for 40 years. Noting that we were "faced with the unsettling fact that [the taxpayer] apparently has converted a patently nondepreciable asset to one which is depreciable by simply relinquishing part of its interest in that property" (74 T.C. at 680 (see also 693 F.2d at 72)), this Court, relying on *Georgia Railroad*, held that the retention of an interest which was created by a division of property is distinguishable from the purchase of a similar interest. 74 T.C. at 683. Because the underlying property was nondepreciable land, and the taxpayer merely separated it into two interests without any separate investment in the retained estate, we held that the taxpayer was not entitled to amortize its basis in the term interest. 74 T.C. at 684. Our rationale was adopted by the Court of Appeals for the Ninth Circuit. 693 F.2d at 72–73.

In the instant case, the property in question is bonds, a type of property generally considered to be nonamortizable. See 4 J. Mertens, Law of Federal Income Taxation, sec. 23.49 (1980); see also sec. 1.167(a)–3, Income Tax Regs.[8] In form, Dr. Gordon purchased term interests in the income from the bonds, and the trusts purchased remainder interests therein. Technical considerations of title or the law of trusts, however, are not so important as the substance of the transaction in question; thus, formally separate steps in an integrated and interdependent series that is focused on a particular end result will not be afforded independent significance in situations in which an isolated examination of the steps will not lead to a determination reflecting the actual overall result of the series of steps. *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Helvering v. Clifford*, 309 U.S. 331, 334 (1940); *Griffiths v. Helvering*, 308 U.S. 355, 357–358 (1939); *Professional Services v. Commissioner*, 79 T.C. 888, 913 (1982). In short, while not ignoring the form by which the transaction involved herein was accomplished, we will look primarily to the substance of what occurred. In so doing we think it important to note that what is involved in this case is a simultaneous joint acquisition of income interests and remainder interests where the consideration moved to a third party who was not in any way concerned with the arrangements between the joint acquirers. In this respect, the instant situation is distinguishable from that involved in the decided cases wherein an amortization deduction was allowed in respect of a purchased term interest; in those cases, only two parties were involved and consideration moved directly between them. See cases cited *supra* pp. 322–323. In the context of a simultaneous, joint acquisition from a third party, it is appropriate to take into account the fact that the participation of the acquirer of the remainder interest is an essential element in affording the acquirer of the income interest the opportunity to obtain the tax benefit of an amortization deduction.[9] This is particularly significant where the acquirer of the income interest and the acquirer of the remainder interest are related persons. If the facts in this case, evaluated in the context of the foregoing considerations, lead to the conclusion that Dr. Gordon in substance purchased full ownership of the bonds and transferred remainder interests to the trusts,[10] the rationale of *Lomas Santa Fe, Inc. v. Commissioner, supra*, and *United States v. Georgia Railroad & Banking Co., supra*, requires a holding that Dr. Gordon did no more than attempt to create an amortization deduction by splitting nondepreciable assets and that respondent's disallowance of the claimed deduction should be sustained.

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[8] *Scheid v. Commissioner*, T.C. Memo. 1983–427.

Petitioners have the burden of proving that respondent's determination is erroneous. Rule 142(a), Tax Court Rules of Practice and Procedure. Moreover, where, as here, both parties to the transactions in question are related, the level of skepticism as to the form of the transaction is heightened, because of the "greater potential for complicity between related parties in arranging their affairs in a manner devoid of legitimate motivations." *Vaughn v. Commissioner*, 81 T.C. 893, 908 (1983); see *Bowen v. Commissioner*, 78 T.C. 55, 78 (1982), affd. 706 F.2d 1087 (11th Cir. 1983). However, this skepticism does not extend to a presumption that, where the settlor and trustee of a trust are husband and wife, the trustee will act in accordance with the settlor's wishes. *Phipps v. Commissioner*, 137 F.2d 141, 144 (2d Cir. 1943); *Newman v. Commissioner*, 1 T.C. 921, 924 (1943); cf. sec. 672(c); *Gutchess v. Commissioner*, 46 T.C. 554, 558–559 (1966) (Tannenwald, J., concurring). Taxpayers have the right to decrease or avoid their taxes by means that the law permits, *Gregory v. Helvering*, 293 U.S. 465, 469 (1935); on the other hand, where as is the case herein, there is such a marked pattern of tax benefits, we may view such pattern as "a yellow caution signal on our road to decision." See *Schultz v. Commissioner*, 50 T.C. 688, 694 (1968), affd. per curiam 420 F.2d 490 (3rd Cir. 1970).

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[9] Here again, the absence of the movement of consideration between the joint acquirers herein sets this situation apart from that involved where the acquirer of an income interest pays the owner of the entire property for that interest and the owner retains the remainder interest. Even in the latter instance, the transaction may be suspect if such ownership was acquired at a point of time close to the time when the income interest was transferred, particularly where the owner of the entire property and the acquirer of the income interest are related persons.

[10] We note that, for purposes of our decision herein, it is unnecessary to decide whether Dr. Gordon made gifts to the trusts of the remainder interests; the deductibility of the amortization depends solely on whether in substance Dr. Gordon purchased whole bonds or term interests in the income therein.

Petitioners cite cases in which courts have refused to recharacterize formal gifts of corporate stock to charitable foundations immediately before the redemption of the shares (*Behrend v. United States*, an unreported case (4th Cir. 1972, 31 AFTR 2d 73–406, 73–1 USTC par. 9123); *Palmer v. Commissioner*, 62 T.C. 684 (1974), affd. on another issue 523 F.2d 1308 (8th Cir. 1975)), and cases upholding installment sale treatment for sales to a purchaser related to the seller occurring immediately before resale by the purchaser (*Weaver v. Commissioner*, 71 T.C. 443 (1978), affd. 647 F.2d 690 (6th Cir. 1981); *Roberts v. Commissioner*, 71 T.C. 311 (1978), affd. 643 F.2d 654 (9th Cir. 1981); *Pityo v. Commissioner*, 70 T.C. 225 (1978); *Rushing v. Commissioner*, 52 T.C. 888 (1969), affd. 441 F.2d 593 (5th Cir. 1971)). Respondent cites cases in which trusts were found to be convenient conduits in the context of denying interest deductions for debt to the trusts (*Perrett v. Commissioner*, 74 T.C. 111, 133–134 (1980), affd. without published opinion 679 F.2d 900 (9th Cir. 1982); *Elbert v. Commissioner*, 45 B.T.A. 685 (1941)), and recent installment sale cases in which the Court scrutinized the economic, non-tax substance of the related party's role in the transaction (*Wrenn v. Commissioner*, 67 T.C. 576 (1976); see also *Vaughn v. Commissioner, supra;*

Bowen v. Commissioner, supra). While each of these cases discusses analogous situations, none is relevant to the issue herein—i.e, whether, in substance, petitioners have attempted to create a deduction by splitting nondepreciable property. Keeping in mind that the issue of substance over form arises "in factual scenarios that do not bear precise repetition" (see *Bowen v. Commissioner, supra* at 79), we think that, while somewhat analogous, these cases are sufficiently distinguishable in terms of their factual context and the issue involved so as not to furnish any significant guidance in reaching our decision herein.

We turn first to the agreements with the family trust. The agreement of July 10, 1974—the first joint purchase agreement involving the family trust—may be disposed of easily. Unlike the situation with all the later purchase agreements, the record contains no evidence that the family trust ever made any payments pursuant to the agreement of July 10, 1974. The record includes no payments by Mrs. Gordon as trustee for remainder interests purchased, and the relevant Ferris & Co. statement shows one payment credit, rather than two partial credits, for each of the bonds. Thus, petitioners have clearly not satisfied their burden of proving that Dr. Gordon did not purchase the July 10, 1974, bonds in full and then transfer remainder interests to the family trust, with the result that, under *United States v. Georgia Railroad & Banking Co., supra*, and *Lomas Santa Fe, Inc. v. Commissioner, supra*, petitioners' amortization deductions with respect to the income interests in these bonds were properly disallowed.

The other joint purchase agreements with the Family Trust, while somewhat tougher calls, require the same result.[11] To be sure, the remainder interests were all paid for with checks endorsed over by Mrs. Gordon as trustee of the family trust, and the Ferris & Co. monthly statements show partial payment credits for each bond, reflecting the allocation between the income and remainder interests. However, the facts concerning Mrs. Gordon, the family trust's cash picture, and petitioners' gift-tax treatment of the bulk of their cash transfers to the family trust point to the conclusion that Dr. Gordon bought the whole bonds, using the family trust as a mere stopping place for a portion of their purchase prices.

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[11] We think it of some significance that the purchase agreements with the family trust did not contain the 25-year cutoff of Dr. Gordon's income interests contained in the purchase agreement with the pension trust, which was recommended "To protect the trust and assure that its return on its investment would not fall below a 4 percent compounded rate." See *supra* pp. 311–312. We also note that the advice contained in the letter from Messrs. Diamond and Johnson (see *supra* pp. 311–313) made no mention of using the family trust.

The family trust was established, after its predecessor trust had ceased to exist, some 27 months prior to execution of the first purchase agreement involving the family trust and some 10 months before execution of the purchase agreement with the pension trust, which was used only because the family trust lacked cash funds at that time. Dr. Gordon had become aware of the bond investment strategy some 3 months before the first purchase agreement was executed. Mrs. Gordon opened a savings account for the family trust just 1 day before the first bond transaction involving the family trust took place, and Dr. Gordon apparently paid for both the income and remainder interests purchased pursuant to that transaction because the family trust's cash position did not permit its participation. In this connection, we note that this was the case even though the family trust had stock holdings that, if a portion thereof had been sold, would have provided sufficient cash to permit such participation. The foregoing circumstances indicate that the family trust was intended to be used as a vehicle for implementing Dr. Gordon's investment strategy only to the extent that is was provided with sufficient cash funds by petitioners or other related entities.[12]

The later operations of the family trust also indicate that the trust made no real purchases, but was merely a way station for the accumulation of cash provided for the most part by petitioners. During 1975, there were no bond transactions and the bank account was fairly inactive. In 1976, at least $78,140.64 of the deposits totaling $95,043.94 (over 82 percent) came from Dr. Gordon,[13] and only $32,775 of this amount was reported by petitioners on their gift tax returns. Petitioners' failure consistently to treat as gifts the amount they contend were given to the trust as gifts is indicative of use of the trust as a mere stopping place for the cash used to enable Dr. Gordon to purchase his income interests. Moreover, $47,591.76 of the 1976 withdrawals from the account totaling $51,319.71 (over 92 percent) was used to implement bond acquisition transactions, and $1,332.81 was left in the account after such transactions were completed. In 1976, then, the trust appears to have been funded for little purpose other than to participate with Dr. Gordon in the implementation of his bond acquisition strategy, a fact that further indicates that Dr. Gordon should be treated as the true purchaser of the whole bonds.

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[12] Dr. Gordon testified that he never considered the possibility of the family trust selling some of its stockholdings and using the cash proceeds to participate in the implementation of the bond purchase agreements. In fact, the record indicates that in the 2 years (1972 and 1975) in which the family trust sold some of its common stockholdings, the proceeds were promptly reinvested in other stocks.

[13] Petitioners state on brief that the deposits to the family trust account "included deposits of the investment income of the [children's] Individual Trusts, the trusts established by Freda Gordon (Dr. Gordon's mother) during her life, the trusts established by the Estate of Freda Gordon, gifts from [petitioners] and its own investment earnings." Respondent computed the maximum amount of income *available* for deposit from the children's various trusts for 1976 and 1977, and petitioners did not object to these computations in their reply brief. We have computed the amount for 1978 in a manner identical to that used by respondent for 1976 and 1977, and have included such amount in our findings of fact.

Similarly, during 1977, at least $58,099.74 of the deposits to the bank account totaling $78.458.89 (over 74 percent) came from Dr. Gordon, and none of this amount was reported by petitioners on their gift tax returns. All of the 1977 withdrawals from the account totaling $97,852.92 were used in implementing the bond transactions, and $3,066.44 and $1,055.67, respectively, remained in the account after the transactions encompassed by the two 1977 purchase agreements were completed. During 1978, at least $56,386.38 of the deposits totaling $91,431.61 (over 61 percent) came from Dr. Gordon, and none of this amount was reported by petitioners on their gift tax returns. Of the 1978 withdrawals from the account totaling $71,963.35, $48,713.35 (almost 68 percent) was used to implement the bond transactions, and $3,846.44 remained in the account after such transactions were completed. Thus, the evidence indicates that Dr. Gordon funded the trust in order to enable himself to enter the bond transactions with a third party.

Finally, Mrs. Gordon's role as trustee further reveals the substance of the transactions. While a business degree recipient who read investment periodicals, Mrs. Gordon apparently did not have an independent role in the decisions to purchase the bonds. When asked at trial whether she inquired into the income yield used in calculating the cost of the remainder interest to the trust, she said she thought doubling the trust's investment was "a good deal," despite the uncertainty as to how long it would be before the trust received the proceeds. Mrs. Gordon professed an inability to understand questions about rate of return on investment, and never thought about whether or how, i.e., as ordinary income or capital gain, the gain on the excess of the proceeds of the bonds over the amounts provided by the family trust would be taxable. This lack of knowledge of and indifference to the ultimate tax consequences to the family trust, coupled with the obvious uncertainty as to Dr. Gordon's life span and future earning potential and the fact that most of the bonds would mature long after the expiration of Dr. Gordon's life expectancy, casts serious doubt on the independent role of Mrs. Gordon as trustee.[14]

In sum, we hold that the petitioners have failed to carry their burden of proof that the family trust was the purchaser of the remainder interests and that, in substance, Dr. Gordon was not the purchaser of the whole bonds and the family trust the transferee of the remainder interests from him.

We reach the same conclusion with respect to the first joint purchase agreement with the pension trust. The record in regard to the status of the pension trust is extremely sparse. The pension plan, but not the trust agreement, is in evidence (see *supra* note 1), so that we have no hint as to Dr. Gordon's powers as trustee over the trust income and corpus. Nor does the record contain any probative evidence as to the financial activity or the financial status of the pension trust for the period of the first 3 months of 1973, when the first purchase agreement was executed and implemented. The only evidence of record as to the financial picture of the pension trust is represented by the Annual Employer's Return for Employees' Pension or Profit Sharing Plans (Form 4848) and the Financial Statement of Employers' Pension or Profit Sharing Fund or Fiduciary Account (Form 4849) for the period July 1, 1973, to June 30, 1974. The former document merely indicates the amounts claimed to have been contributed by Dr. Gordon's professional corporation for the fiscal year periods ending on each year commencing with June 30, 1970, through June 30, 1974. Clearly, the foregoing evidence is insufficient to enable petitioners to carry their burden of proof that the pension trust was the purchaser of the remainder interests in the 1973 transaction and that, in substance, Dr. Gordon was not the purchaser of the whole bonds and the pension trust merely the transferee of the remainder interests from him.[15] Nor can that burden be satisfied by concluding that the fact that the pension trust was a qualified exempt organization under section 401, et seq. (which respondent does not dispute) establishes its independence for the purpose of determining the issue involved herein.

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[14] Describing the decision-making process between herself and Dr. Gordon, Mrs. Gordon testified as follows:

"And I would say, 'Everett, look how much we have got here, let's put it into something.' So we'd say whether we were going into a real estate venture or, and then I would say, 'Look what the children, how much the children have in that family trust at the bank. * * * Let's buy another life tenant agreement.' "

We do not consider this testimony indicative that Mrs. Gordon, as trustee, played an independent role in determining the implementation of the bond investment strategy. Rather, we think it indicates that Mrs. Gordon was simply saying to her husband that the family trust was in a position to enable *him* to execute *his* strategy.

Based upon the foregoing analysis, the rationale of *United States v. Georgia Railroad & Banking Co, supra* and *Lomas Santa Fe, Inc. v. Commissioner, supra*, dictates the conclusion that the amortization deductions were properly disallowed.[16]

Due to concessions by the parties,

Decision will be entered under Rule 155.

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[15] Even if we were inclined to be lenient and to accept evidentiary material on this issue set forth in the parties briefs, it would not be of any avail to petitioners, since neither party's briefs contain any helpful material.

[16] We reject petitioners' argument that the fact that the trust was free to refuse to participate in any or all of the joint purchase transactions indicates that the trust's role as purchaser had substance. For purposes of this question, the power to refuse is a fact to consider (see *Allen v. Commissioner*, 66 T.C. 340, 347-348 (1976)), but is of minimal significance where, as here, the facts reveal that the entire transaction was set up around the expectation that the joint implementation of the Gordon's investment strategy would occur. See *Blake v. Commissioner*, 697 F.2d 473, 478-481 (2d Cir. 1982), affg. a Memorandum Opinion of this Court. Compare *Buehner v. Commissioner*, 65 T.C. 723 (1976), a case relied upon by petitioners and which we find distinguishable on its facts.

Given our holding herein, we need not decide whether respondent's argument based on the grantor trust provisions (sec. 671, et seq.), adverted to for the first time in respondent's trial memorandum, was made too late to be considered. See *Johnsen v. Commissioner*, 83 T.C. 103, 120 (1984); *Aero Rental v. Commissioner*, 64 T.C. 331, 338 (1975).

Michael S. and Marilyn H. Falsetti, et al.,[1] Petitioners v. Commissioner of Internal Revenue, Respondent

Docket Nos. 7013–82, 5437–83, 5438–83, 7111–83, 20833–83. Filed August 21, 1985.

Ps were limited partners in M, a California limited partnership. M purportedly purchased an apartment complex (the property) from W, a Cayman Islands corporation, which purportedly purchased the property from H. M purportedly made interest payments to W. Ps were subsequently "cashed out" by H for the amount of their capital contributions plus 10 percent per annum simple interest. *Held*, the totality of the facts and circumstances surrounding the alleged sale transactions demonstrates that the purported sales were shams in substance, as defined for purposes of this case, and therefore M was not engaged in a bona fide business activity sufficient to pass through any deductions to Ps. *Held, further*, since the purported interest payments by M were in reality the mere shifting by H of funds under his dominion and control, and were not paid to W, M is not liable for the 30-percent withholding tax under sec. 1442, I.R.C. 1954, or the addition to tax under sec. 6651(a), I.R.C. 1954, for failure to file a return.

Fs owned all of the stock of C. C paid certain amounts relating to auto, boat, travel, insurance, and other unidentified expenses for the benefit of Fs. *Held*, amount of constructive dividends from C to Fs determined.

Thomas W. Harris, Jr., for the petitioners.
Theodore Garelis, for the respondent.

NIMS, *Judge*: Respondent determined the following deficiencies and additions to tax in petitioners' income taxes for the taxable years ending December 31:

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[1] Cases of the following petitioners are consolidated herewith: Frank J. and Marsha L. Cuttone, docket No. 5437–83; Louis W. and Sandra M. Bittner, docket No. 5438–83; J. Neil and Helen Medefind, docket No. 7111–83; Monterey Pines Investors (also known as Monterey Pines Investors I), docket No. 20833–83.

Case	*Docket No.*	*Year*	*Deficiency*	*Additions to tax sec. 6651(a)*[2]
Falsetti	7013–82	1976	$3,590	
		1977	5,383	
		1978	12,546	
Cuttone	5437–83	1976	1,925	
		1977	16,013	
Bittner	5438–83	1976	2,335	
		1977	12,420	
Medefind	7111–83	1974	3,404	
		1976	5,337	
		1977	9,885	
Monterey Pines Investors	20833–83	1976	14,250	$3,563
		1977	123,279	30,820

After concessions, the issues for decision are: (1) Whether Monterey Pines Investors was engaged in a bona fide business activity during 1976 and 1977; (2) the amount, if any, of depreciation expenses petitioners are entitled to claim; (3) whether petitioners are entitled to interest expense deductions; (4) whether petitioners are entitled to deduct certain legal expenses; (5) whether petitioner, Monterey Pines Investors, actually or constructively paid interest to a foreign corporation; (6) whether section 1461 (relating to "Liability for Withheld Tax") required Monterey Pines Investors to file a return and pay the tax imposed by section 1442 (relating to "Withholding of Tax on Foreign Corporations"); (7) whether a section 1442 tax of 30 percent of such interest payments should have been withheld at the source by Monterey Pines Investors; (8) and if so, whether Monterey Pines Investors is liable for the section 6651(a) addition to tax for the non-filing of Form 1042 (U.S. Annual Return of Income Tax to be Paid at Source) for the years 1976 and 1977; and (9) whether petitioners Michael and Marilyn Falsetti received constructive dividends from their wholly owned corporation, Mikomar, Inc., in the years 1977 and 1978.

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[2] All section references are to the Internal Revenue Code of 1954 and in effect for the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Certain facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

The following petitioners are individuals who resided in California at the time of filing of the petitions herein:

Petitioners	*Docket No.*
Michael S. and Marilyn H. Falsetti (collectively Falsetti)	7013–82
Frank J. and Marsha L. Cuttone (collectively Cuttone)	5437–83
Louis W. and Sandra M. Bittner (collectively Bittner)	5438–83
J. Neil and Helen Medefind (collectively Medefind)	7111–83

Petitioner Monterey Pines Investors (also known as Monterey Pines Investors I, a California limited partnership, hereinafter referred to as Monterey Pines Investors), is a California limited partnership with its principal place of business in California.

Monterey Pines Investors

Monterey Pines Investors was formed in March 1977, with Lloyd V. Biggs (Biggs) as the general partner and the individual petitioners (as well as others who are not petitioners in this case) as limited partners. The Certificate of Limited Partnership was signed on behalf of the limited partners by Biggs on March 15, 1977, and was recorded in the official records of Fresno County, California, on March 16, 1977.

The individual petitioners contributed the following amounts of cash at the time of their investment in Monterey Pines Investors:

Falsetti	$7,500
Cuttone	7,500
Bittner	7,500
Medefind	10,000

All individual petitioners made their contributions in December 1976.

Monterey Pines Apartments (the property) is an apartment complex located at 445 West Bullard Avenue, Fresno, California. Prior to October 21, 1976, the property was owned jointly by Gardner Motors, Inc., Sunnyside Volkswagen, Inc., and Fresno Economy Import Used Cars (collectively referred to as the Gardner Group). The fair market value of the property on November 1, 1976, was no greater than $1,960,000.

In May 1976, the Gardner Group entered into negotiations to sell the property to G & G Investors for $1,880,000. G & G Investors is a California limited partnership with Daniel Grayson, Richard A. Denman, and John E. Sims as general partners. A proposed purchase price of $1,869,500 was also seriously discussed as late as September 1976. The sale of the property to G & G Investors was never consummated.

On October 21, 1976, Thomas W. Harris, Jr. (Harris), and Donald L. Jackson formed a general partnership called Jackson-Harris, Monterey Pines Investors (hereinafter Jackson-Harris). One or both of the partners in Jackson-Harris borrowed $250,000 from the Bank of America (the Bank of America loan). The proceeds of this loan were contributed to Jackson-Harris as the capital contribution of one or both of the partners.

On October 21, 1976, the Gardner Group sold the property to Jackson-Harris for $1,880,000. The Bank of America loan proceeds were used as a downpayment on the Agreement of Purchase and Sale Land Contract to acquire the property. Harris located the property and negotiated the terms of purchase on behalf of Jackson-Harris. Jackson-Harris, the Gardner Group and G & G Investors were all unrelated parties, and negotiations were conducted at arm's length.

The Agreement of Purchase and Sale Land Contract provides for the payment of the purchase price as follows:

> 2. *Purchase Price.* Vendor agrees to sell, and Vendee agrees to buy the Project for the sum of ONE MILLION EIGHT HUNDRED AND EIGHTY THOUSAND DOLLARS ($1,880,000.00) (hereinafter "Purchase Price") lawful money of the United States, which shall be payable or evidenced as follows:
>
> (a) The sum of TWO HUNDRED FORTY-FOUR THOUSAND AND FOUR HUNDRED DOLLARS ($244,400.00) hereinafter "Down Payment") in the form of cash, cashier's check or certified check through and at close of TITLE INSURANCE AND TRUST Escrow Number 241701-T.
>
> (b) The sum ONE MILLION SIX HUNDRED THIRTY-FIVE THOUSAND SIX HUNDRED DOLLARS ($1,635,600.00) (hereinafter "Balance of Purchase Price") as follows:

(1) The sum of ELEVEN THOUSAND NINE HUNDRED NINETY-FOUR AND 40/100 DOLLARS ($11,994.40) in monthly installments beginning December 1, 1976 and on the first (1st) day of each and every month thereafter for sixty (60) consecutive calendar months. Said sum represents interest only at eight and eight-tenths percent (8.8%) per annum on the principal balance of ONE MILLION SIX HUNDRED THIRTY-FIVE THOUSAND SIX HUNDRED DOLLARS ($1,635,600.00); and

(2) The full amount of the balance of the Purchase Price shall be paid on or before November 1, 1981 or by that date the Underlying Note (as hereinafter described) shall be assumed and the difference between the principal amount of that note and the Purchase Price shall be paid to Vendor. Vendee will assume liability for the commission to be paid to GERALD R. RODDER or nominee.

(c) In addition to the monthly payment as hereinabove provided, Vendee assumes and agrees to pay before delinquency all real property taxes and assessments, and Vendee shall reserve each month during the term of this Agreement a sum equal to one-twelfth (1/12th) of the amount of real property taxes assessed and levied against the Project (hereinafter "Impounds") which sum shall be paid as hereinafter provided. Said Impounds shall all be computed on the basis of the most recent tax bill available and shall be adjusted periodically to maintain an adequate reserve account for the timely payment of real property taxes.

Jackson-Harris and the Gardner Group executed a Memorandum of Agreement evidencing the October 21, 1976, sale of the property simultaneously with the Agreement to Purchase and Sale Land Contract. The Memorandum of Agreement was duly recorded on the same date.

On October 25, 1976, Jackson-Harris executed a document entitled "Agreement of Purchase and Sale Land Contract" for the sale of the property to an entity known as World Realty Systems, Inc., a Cayman Islands corporation (also known as World Realty, Inc., hereinafter World Realty). World Realty is a foreign corporation owned by George Kuchulis (Kuchulis). The stated purchase price under the agreement was $2,180,000. The document in question contains no evidence of recordation, nor is any Memorandum of Agreement showing recordation in evidence.

Harris represented both parties to the October 25, 1976, transaction and executed the agreement by signing for both parties. He signed for World Realty as "Attorney in Fact." Harris' power of attorney authorizing him to sign for World Realty is not in evidence. The stated purchase price of $2,180,000 and all other terms of the agreement were unilaterally set by Harris. Harris did not communicate with Kuchulis, World Realty, or World Realty's Cayman Island attorney at any time before or after the transaction.

Specifically, in connection with the sale to World Realty, Harris never informed anyone connected with World Realty that: (1) Jackson-Harris was interested in selling the property; (2) Harris owned a 50-percent interest in the property as a partner in Jackson-Harris; (3) the property had been purchased 4 days earlier by Jackson-Harris for $1,880,000; (4) Harris executed the purchase agreement and sale land contract on behalf of World Realty; or that (5) the stated purchase price was $2,180,000 and subject to the terms as delineated in the agreement. Subsequently, Harris never informed anyone connected with World Realty that the property was sold to Monterey Pines Investors by Harris on behalf of World Realty for $2,850,000 and subject to the terms of a November 1, 1976, agreement of purchase and sale land contract between World Realty and Monterey Pines Investors dated November 1, 1976.

There were no appraisals done by either Jackson-Harris or World Realty relating to the fair market value of the property on or before October 25, 1976. World Realty has never held legal title to the property. Title insurance was never obtained on the property either by World Realty or on its behalf.

The October 25, 1976, Agreement of Purchase and Sale Land contract provides for the payment of the purchase price as follows:

> 2. *Purchase Price.* Vendor agrees to sell, and Vendee agrees to buy the Project for the sum of TWO MILLION ONE HUNDRED EIGHTY THOUSAND DOLLARS ($2,180,000.00) (hereinafter "Purchase Price") lawful money of the United States, which shall be payable or evidenced as follows:
>
> (a) Vendee shall take subject to encumbrances specified in that Agreement of Purchase and Sale Land Contract dated October 21, 1976 by and between GARDNER MOTORS, INC., et al and MONTEREY PINES INVESTORS, a California General Partnership.
>
> (b) Vendee shall make such payments as are necessary to allow Vendor to repay loan of Two hundred fifty thousand dollars ($250,000.00) to Bank of America, National Trust and Savings Association, Selma Branch on such terms and conditions as from time to time are satisfactory to the bank.
>
> (c) The balance of the purchase price of Three hundred thousand dollars ($300,000.00) shall be payable to Vendor on a Ten (10) year installment payment at five percent (5%) interest with no principal reductions during the first Five (5) years with principal being reduced in Sixty (60) equal monthly installments starting January 1, 1982 with interest on unpaid

> balance at Ten percent (10%). Interest accrues until November 1, 1979 and is payable monthly thereafter.
>
> (d) With regard to all other terms and conditions, Vendee takes subject to and shall be bound by the Purchase and Sale Land Contract by which Vendor took title described in detail above and attached hereto as Exhibit "A."

On November 1, 1976, Harris executed a document on behalf of World Realty entitled "Agreement of Purchase and Sale Land Contract" for the sale of the property by World Realty to Monterey Pines Investors. Biggs executed the document on behalf of Monterey Pines Investors as the general partner. The document in question bears no evidence of recordation, nor is any Memorandum of Agreement showing recordation in evidence.

Harris and Biggs were related both personally and professionally. Biggs was the brother-in-law of Harris' brother-in-law. Biggs worked for and subsequently became part owner of a management company known as Calamity Corp. Calamity Corp. was at one time wholly owned by Harris. Harris sold all of his stock in Calamity Corp. to Biggs and an individual named Weersing (Harris' father-in-law) in equal amounts. Thereafter, Harris paid fees to Calamity Corp. to manage certain real estate projects.

Harris unilaterally set the terms of the November 1, 1976, transaction, including the purchase price of $2,850,000. There were no appraisals of the property made in connection with the transaction of November 1, 1976. Monterey Pines Investors never held title to the property nor was title insurance on the property ever obtained by or on behalf of Monterey Pines Investors.

The November 1, 1976, Agreement of Purchase and Sale Land Contract between World Realty, as vendor, and Monterey Pines Investors, as vendee, contains the following provisions:

> 2. *Purchase Price.* Vendor agrees to sell, and Vendee agrees to buy the Project for the sum of TWO MILLION EIGHT HUNDRED AND FIFTY THOUSAND DOLLARS ($2,850,000.00) (hereinafter "Purchase Price") lawful money of the United States, which shall be payable or evidenced as follows:
>
> (a) The sum of FORTY-SEVEN THOUSAND FIVE HUNDRED DOLLARS ($47,500.00) to be paid in cash prior to December 31, 1976 as interest at ten

percent (10%) per annum simple interest for the period from November 1, 1976 through December 31, 1976; and,

(b) Interest only shall be payable monthly from and after January 1, 1977 at the rate of ten percent (10%) per annum, which is TWENTY THREE THOUSAND SEVEN HUNDRED FIFTY and no/100 DOLLARS ($23,750.00).

(c) On or about November 1, 1981 Vendee shall make a principal payment to Vendor sufficient for Vendor to make the payment on its underlying contract of sale.

(d) In addition to the monthly payment as hereinabove provided, Vendee assumes and agrees to pay before delinquency all real property taxes and assessments, and Vendee shall reserve each month during the term of this Agreement a sum equal to one-twelfth (1/12th) of the amount of real property taxes assessed and levied against the Project (hereinafter "Impounds") which sum shall be paid as hereinafter provided. Said Impounds shall be computed on the basis of the most recent tax bill available and shall be adjusted periodically to maintain an adequate reserve account for the timely payment of real property taxes.

Books of account relative to the property transactions at issue here were maintained by Harris for both Jackson-Harris and Monterey Pines Investors. The following journal entries were recorded in the Jackson-Harris books to reflect the acquisition of the property by Jackson-Harris from the Gardner Group on October 21, 1976:

Item	*Debits*	*Credits*
Impound account	$13,122.84	
Land and building	1,880,330.00	
Deposits	14,631.53	
Contract payable		$1,635,600.00
Property tax		13,122.84
Security deposit		8,145.33
Prepaid rents		1,216.20
Capital		250,000.00

To record the purchase of the
Monterey Pines complex on 10/21/76

The following journal entries were recorded in the Jackson-Harris books to reflect the purported sale of the property by Jackson Harris to World Realty on October 25, 1976:

Item	*Debits*	*Credits*
Receivable from World Realty Systems, Inc.	$3,761.31	
Drawings	0	

Item	*Debits*	*Credits*
Security deposits	$8,145.33	
Prepaid rents	1,216.20	
Note receivable-World Realty Systems, Inc.	2,180,000.00	
Impound account		$13,122.84
Land and building		1,880,330.00
Deferred gain		299,670.00

To record the sale of Monterey Pines
to World Realty Systems, Inc. on 10/25/76

To reflect the acquisition of the property from World Realty by Monterey Pines Investors, an accounting entry in the books and records was made crediting a liability account (hereinafter note payable, World Realty) in the amount of $2,850,000. Monterey Pines Investors did not make payments directly to World Realty and World Realty did not make payments directly to Jackson-Harris.

Monterey Pines Investors made the following payments during the calendar year 1977:

Check No.	*Payee*	*Amount*	*Date*
147	Bank of America	$11,994.40	1/17/77
192	Bank of America	11,994.40	2/25/77
102	Bank of America	10,000.00	3/ 7/77
107	Bank of America	11,994.40	3/10/77
131	Bank of America	15,000.00	4/ 8/77
134	Bank of America	11,994.40	4/12/77
156	Bank of America	11,994.40	5/12/77
197	Bank of America	11,994.00	6/10/77
228	Monterey Pines	11,994.00	7/12/77
250	Bank of America	241,996.87	8/ 4/77
256	Monterey Pines	11,994.00	8/12/77
300	Monterey Pines	11,994.40	9/12/77
334	Monterey Pines	11,994.40	10/11/77
361	Monterey Pines Apartments	11,994.40	11/14/77
389	Monterey Pines Apartments	11,994.40	12/11/77
Total, 1977		[3]410,929.67	

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[3] The total stipulated, $410,929.67, reflects monthly payments of $11,994.40 (the monthly amounts due from Jackson-Harris to the Gardner Group), whereas the checks dated 6/10/77, 7/12/77, and 8/12/77 reflect payments of only $11,994.00 each. For convenience, we have used the $410,929.67 stipulated figure throughout this opinion, although the correct total is $410,928.47 ($1.20 less than the total stipulated).

Monterey Pines Investors recorded on its books of account for 1977 the above payments as follows:

	Cumulative debits	*Cumulative credits*
Note payable, World Realty	$250,000.00	
Interest expense	160,929.67	
Cash		$410,929.67

On December 31, 1977, an adjusting journal entry was made which increased the note payable, World Realty account and increased the interest expense account as follows:

	Debit	*Credit*
Interest expense	$65,053.53	
Note payable, World Realty		$65,053.53

The payments made by Monterey Pines Investors were treated by Monterey Pines Investors and Jackson-Harris as if said amounts had been paid to World Realty by Monterey Pines Investors, followed by the payment of said amounts to Jackson-Harris by World Realty. Monterey Pines Investors deducted interest expenses of $233,333 on its 1977 partnership return, of which $225,983 was attributable to the $410,929.67 in payments set forth above. On its 1977 partnership return, Jackson-Harris reported interest income from World Realty of $114,625 and a reduction in the amount due to it from World Realty of $296,305. Jackson-Harris also deducted interest expenses of $143,933 in the same year.

Jackson-Harris originally made entries on its books and records reflecting receipt of interest income of $217,650.56 from World Realty and a reduction in the amount of principal due from World Realty of $193,279.11. Daniel Sugimoto, the C.P.A. who prepared the 1977 Jackson-Harris partnership return, prepared a return in accordance with the original book entries but subsequently changed the return after showing it to Harris. Sometime after October 1978, the books and records of Jackson-Harris were changed to reflect interest income of $114,624.70 for 1977.

On August 4, 1977, Biggs, as general partner of Monterey Pines Investors, executed a Deed of Trust and Assignment of Rents on the property for the purpose of securing a promissory note in the amount of $275,000 from Jackson-Harris to

Warren E. and Melda Johnson. On June 15, 1978, Biggs, Harris, and Gary G. Bagdasarian (Bagdasarian) (Harris' law partner), on behalf of Jackson-Harris, executed a Deed of Trust and Assignment of Rents as security for a promissory note in the amount of $300,000 from Jackson-Harris to Valley Radiology Medical Group, Inc. Pension and Profit Sharing Trust. On July 6, 1978, Biggs, as general partner of Monterey Pines Investors, executed another Deed of Trust and Assignment of Rents on the Property as security for a promissory note in the amount of $400,000 from Jackson-Harris to Union Bank of Bavaria. On October 26, 1978, Harris, as general partner of Jackson-Harris, executed a Deed of Trust and Assignment of Rents to secure a subsequent promissory note in the amount of $400,000 from Jackson-Harris to Union Bank of Bavaria.

The proceeds of the promissory notes secured by the June 15, 1978, July 6, 1978, and October 26, 1978, Deeds of Trust and Assignment of Rents inured to the benefit of Harris or Bagdasarian, or both. In all four Deeds of Trust and Assignment of Rents, the address of the trustor (debtor) was the same as the Harris and Bagdasarian law corporation. On July 24, 1978, both Harris and Bagdasarian acknowledged and accepted the terms of the July 5, 1978, loan.

In early 1979, petitioners Falsetti transferred their partnership interest in Monterey Pines Investors to Donald Ward Ozenbaugh, Jr., and Kathryn Ozenbaugh (collectively Ozenbaugh) in exchange for a promissory note in the amount of $7,500 plus 10 percent interest per annum on the principal amount. On March 31, 1979, Ozenbaugh transferred the partnership interest in Monterey Pines Investors acquired from Falsetti to Constellation Properties, Ltd.

Constellation Properties, Ltd. (Constellation) is a corporation wholly owned by Harris. Harris is the president of Constellation. During 1979 and 1980, petitioners Medefind, Cuttone, and Bittner transferred their partnership interests in Monterey Pines Investors to Constellation and/or Harris in exchange for promissory notes in the respective amounts of $53,500, $20,062.50, and $20,062.50. The amounts of the notes represent the partners' capital contributions to the partnership plus 10-percent simple interest per annum on the amounts of the capital contributions from the dates of contribution to the dates their partnership interests were transferred.

Petitioners Falsetti, Cuttone, and Bittner were advised to sell their partnership interests for the above-mentioned terms by Ozenbaugh. Petitioner Medefind was approached by Harris with an offer to purchase Medefind's partnership interests for the terms as specified.

On September 19, 1980, Monterey Pines Partners of Fresno (Monterey Pines Partners) purchased the property for 4,001,000 from Harris. Monterey Pines Partners was a California limited partnership set up by Ozenbaugh. Ozenbaugh was the general partner. Subsequent to the purchase, Monterey Pines Partners leased the property back to Harris.

On July 1, 1983, the property was sold to Fidelity Equities Corp. (Fidelity) by Jackson-Harris for $3,250,000. The agreement of sale was executed by Harris as general partner. At the time of the sale to Fidelity, the Gardner Group grant-deeded the property to Jackson-Harris; Jackson-Harris grant-deeded the property to Monterey Pines Partners; and Monterey Pines Partners grant-deeded the property to Fidelity. The interests of Monterey Pines Investors and World Realty were ignored by the parties at the time of sale of the property to Fidelity.

Constructive Dividends

Petitioners Michael and Marilyn Falsetti (the Falsettis) purchased the building, inventory, and equipment of Farnesi's Restaurant in Chowchilla, California, in January 1976. Petitioners operated the restaurant as a sole proprietorship until August 3, 1976, when the business was incorporated under the name of Mikomar, Inc. (Mikomar). The inventory and equipment of Farnesi's Restaurant was transferred to Mikomar. Mikomar was formed as a California corporation and was wholly owned by the Falsettis. All corporate offices of Mikomar were held by the Falsettis.

Mikomar deducted the following expenses which it paid during the fiscal years ending October 31, 1977, and October 31, 1978, respectively:

	FYE 10/31/77	*FYE 10/31/78*
Auto expenses	$6,417	$13,978
Travel expenses	2,639	526
Boat expense	2,409	2,467

	FYE 10/31/77	*FYE 10/31/78*
Health and life insurance	$373	- - -
Unidentified/unknown	1,264	$2,497
Total	13,102	19,468

A statutory notice of deficiency was issued to Mikomar disallowing all of the above deductions based on respondent's determination that they were personal expenses of the Falsettis and therefore constituted constructive dividends. Mikomar failed to petition the Tax Court, and the amounts asserted in the deficiency notice were assessed. The record contains no indication that Mikomar filed refund claims.

Mikomar paid and deducted auto expenses for the years at issue as follows:

	FYE 10/31/77	*FYE 10/31/78*
Auto expense for year	$2,347	$2,827
Blazer depreciation	2,667	2,667
Blazer hitch depreciation	60	60
Blazer radio depreciation	74	74
Pantera depreciation	968	
Mark V depreciation (3-DDB)		8,272
Repairs	135	
DMV license	96	78
Insurance	70	
Total	6,417	13,978

The Falsettis have conceded that the Pantera and Continental Mark V automobiles were used for personal and not business use.

The Falsettis used the Blazer to pick up wine for the restaurant 1 to 3 times a month from Sangor, California, which is approximately 50 to 60 miles from the restaurant. The Falsettis drove to Fresno, which is approximately 40 miles from the restaurant, to pick up supplies for the restaurant. However, they failed to keep any records as to any business use of the Blazer. The Blazer was also used to tow the Falsettis' boats to various recreational lakes in California when the Falsettis were on vacation, and by them to commute between their home and the restaurant.

Mikomar paid and deducted travel expenses during the years at issue as follows:

	FYE 10/31/77	*FYE 10/31/78*
Damaler Travel Agents	$336	$526
April Point Travel	961	
Baskford Travel Agents	1,342	
Total	2,639	526

During the years at issue, the Falsettis went to Canada by commercial airline to visit Mr. Falsetti's grandparents. The airline tickets were obtained through Baskford Travel Agents. While in Canada, the Falsettis stayed at the April Point Lodge. They failed to present any evidence of a business purpose for the amounts paid to Damaler Travel Agents, April Point Travel, or Baskford Travel Agents.

Mikomar paid and deducted boat expenses during the years at issue as follows:

	FYE 10/31/77	*FYE 10/31/78*
Boat depreciation	$1,500	$2,083
Centurion boat depreciation		250
Prudential Insurance	174	
McClure Pt. Marine	175	
Cecil's Marine	183	
Prudential	139	
Newfield	115	
Madera Marine		134
Total	[4]2,286	2,467

The Falsettis used the boats for personal purposes. No records of any business use were ever maintained.

Health and life insurance payments paid and deducted by Mikomar during its fiscal year ended October 31, 1977, were as follows:

Health insurance	$344
Life insurance	29
Total	373

Michael Falsetti was the only insured party in both policies.

Unidentified expenses paid and deducted by Mikomar during the years at issue were as follows:

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[4] The parties stipulated, without explanation, total boat expenses of $2,409 for the 10/31/77 fiscal year. The correct total of the items stipulated is $2,286.

	FYE 10/31/77	*FYE 10/31/78*
Mr. and Mrs. J. McHaley	$1,000	
Van Del, Inc.	264	
Farmers and Prudential Insurance		$2,497
Total	1,264	2,497

OPINION

Monterey Pines Investors

Jackson-Harris, a California general partnership, purchased Monterey Pines Apartments on October 21, 1976, for $1,880,000 from the Gardner Group by way of an Agreement of Purchase and Sale Land Contract. On October 25, 1976, Jackson-Harris sold the property to World Realty (a Cayman Islands corporation) for $2,180,000, also by way of an Agreement of Purchase and Sale Land Contract. World Realty then sold the property to Monterey Pines Investors, a California limited partnership, on November 1, 1976, for $2,850,000, again by way of an Agreement of Purchase and Sale Land Contract.

The individual petitioners herein were all limited partners of Monterey Pines Investors during the years in issue. Sometime in 1979 and 1980, petitioners sold their interests in Monterey Pines Investors to Harris or Constellation Properties, Ltd. (wholly owned by Harris), for amounts equal to their cash contributions in Monterey Pines Investors plus 10-percent simple interest per annum.

The property was then sold in 1980 to Monterey Pines Partners, a California limited partnership, for $4,001,000 by way of an Agreement of Purchase and Sale Land Contract. The property was then leased back to Harris. On July 1, 1983, the property was sold to Fidelity Equities Corp. by Jackson-Harris for $3,250,000. At the time of the sale to Fidelity, legal title was transferred from the Gardner Group to Fidelity as follows: Gardner Group grant-deeded the property to Jackson-Harris, which grant-deeded the property to Monterey Pines Partners, which grant-deeded the property to Fidelity.

The first issue for decision is whether Monterey Pines Investors was engaged in a bona fide business activity during the years 1976 and 1977. Resolution of this issue is dependent upon a determination of whether Monterey Pines Investors ever acquired an interest in the property.

Petitioners contend that Monterey Pines Investors was in the business of investing in real estate. In accordance with the nature of its business, Monterey Pines Investors "purchased" the property with the expectation that the property would appreciate and result in a gain to the partnership upon sale. To support their contention that Monterey Pines Investors purchased the property, petitioners argue that the Agreement of Purchase and Sale Land Contract between World Realty and Monterey Pines Investors was a legally enforceable and valid vehicle for conveying equitable ownership in real property and therefore not a sham.

Conversely, respondent contends that Monterey Pines Investors never obtained an interest in the property and therefore the partnership could not be considered as having engaged in a bona fide business activity. Respondent argues that the facts and circumstances surrounding the purported equitable transfer of the property demonstrate that the alleged transaction was nothing more than a culmination of a series of sham transactions devoid of economic substance. Respondent therefore concludes that Monterey Pines Investors never acquired an interest in the property which would entitle the individual petitioners to any distributive share of deductions.

After reviewing the record before us, we are convinced that respondent is correct. This is because we have concluded that the purported sale transaction between World Realty and Monterey Pines Investors was in substance a sham. It follows from this that Monterey Pines Investors was not engaged in a bona fide business activity during the years at issue.

Before we give our reasons, we deem it advisable to set forth a working definition of what constitutes a sham in substance, basing our definition upon the rationale of such cases as *Knetsch v. United States*, 364 U.S. 361 (1960), and its progeny, and dictum in *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). For purposes of this case, we define "sham in substance" as the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits. See 435 U.S. at 572.

In the context of a sale transaction, as here, our task is to determine whether the parties have in fact done what the form of their arrangement purports to do. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237 (1981). In other words, we must determine whether World Realty, in fact, sold the property to Monterey Pines Investors.

The term "sale" is given its ordinary meaning for Federal income tax purposes and is generally defined as a transfer of property for money or a promise to pay money. *Commissioner v. Brown*, 380 U.S. 563, 570-571 (1965). In deciding whether a particular transaction constitutes a sale, the question of whether the benefits and burdens of ownership have passed from seller to buyer must be answered. This is a question of fact which must be ascertained from the intention of the parties as evidenced by the written agreements read in light of the attendant facts and circumstances. *Haggard v. Commissioner*, 24 T.C. 1124, 1129 (1955), affd. 241 F.2d 288 (9th Cir. 1956).

Various factors which have been considered by courts in making a determination as to whether a sale occurs were summarized in *Grodt & McKay Realty, Inc. v. Commissioner, supra*, as follows:

> (1) Whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation on the seller to execute and deliver a deed and a present obligation on the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property. [77 T.C. at 1237–1238; citations omitted.]

An additional factor not listed but nonetheless relevant to the facts of this case is the presence or absence of arm's-length dealing. *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975), affd. 544 F.2d 1045 (9th Cir. 1976). With these factors in mind and cognizant of the fact that the totality of the facts and circumstances surrounding the transaction is controlling, we conclude that the purported sale between World Realty and Monterey Pines Investors was a sham in substance and therefore Monterey Pines Investors never acquired an interest in the property.

At no time did legal title ever vest with Monterey Pines Investors. In fact, at the time the property was sold to Fidelity in 1983, the chain of grant deeds conspicuously ignores any interest of World Realty or Monterey Pines Investors. Moreover, neither the sale to World Realty by Jackson-Harris nor World Realty to Monterey Pines Investors was an arm's-length transaction; the stated purchase price to be paid by Monterey Pines Investors, as discussed *infra*, grossly exceeded the then fair market value of the property; and the parties themselves treated the transactions in a manner completely inconsistent with the supporting documents or with the notion that Monterey Pines Investors owned the property.

For reasons unexplained, the purchase and sale documents in the two pertinent transactions reflect an increase in the property's value of $970,000 in 10 days' time. In *Odend'hal v. Commissioner*, 80 T.C. 588, 612 (1983), affd. 748 F.2d 908 (4th Cir. 1984), we commented that "The doubling of the purchase price in such a back-to-back sale makes us question whether the second sales price reflects the fair market value, because there is nothing in the record to indicate how such a dramatic change could have occurred within a few weeks." Here, we question not only the "dramatic change" but the actuality of the sales, themselves.

Harris represented both parties to the October 25, 1976, transaction between Jackson-Harris and World Realty, and he unilaterally set the terms and conditions of the sale. Although Jackson-Harris acquired the property 4 days prior to the sale to World Realty, Harris set the purchase price at $2,180,000, or $300,000 more than what he had just paid. Moreover, Harris failed to inform anyone connected with World Realty that he had bought the property for World Realty or that he held a 50-percent interest in the partnership which was allegedly selling the property. Equally unrealistic is Harris' subsequent failure to notify World Realty that he was selling the property which he had just acquired for World Realty and that its gain in the span of 6 days would be $670,000.

Likewise, the purported sale on November 1, 1976, in which World Realty supposedly sold the property to Monterey Pines Investors was not an arm's-length transaction between unrelated parties. Harris represented World Realty, and Biggs, as general partner, represented Monterey Pines Investors. At the time of the sale, Monterey Pines Investors had no limited partners nor any capital contributions. The individual petitioners did not make capital contributions until more than a month after the purchase and sale transaction. Biggs was a relative by marriage and professionally associated with Harris. Biggs, and Harris' father-in-law, Weersing, were half owners of Calamity Corp. which previously had been wholly owned by Harris and had been sold by Harris to Biggs and Weersing. Calamity Corp. was paid fees by Harris to manage certain real estate ventures of Harris.

The terms and conditions of the alleged sale to Monterey Pines Investors were again unilaterally set by Harris. On this point, Harris testified as follows:[5]

> Q. How was the $2,850,000 price in regard to the November 1st transaction, determined?
>
> A. I can't recall if there was a formula or anything, but I set the price.
>
> Q. Unilaterally?
>
> A. Yes.
>
> Well, I shouldn't say yes. I sat down and discussed it with Mr. Biggs at the time, so I—in that case I would have to say no. Not unilaterally.
>
> But I had the final authority to say yes or no to any terms, so that is why I say technically yes.

We deem this to be an admission by Harris that he alone determined the purchase price. In sum, based on Harris' familial and professional relationship with Biggs as well as Harris' own testimony, we conclude that the alleged November 1, 1976, transaction was not at arm's length.

Further doubt as to the bona fides of the transaction is raised by the drastically inflated sales price. We have found as a fact that the fair market value of the property at the time of the sale to Monterey Pines Investors on November 1, 1976, was no greater than $1,960,000. That finding comports not only with the valuation by respondent's expert witness, which was unrefuted by petitioners, but also with the purchase price of $1,880,000 paid by Jackson-Harris to the Gardner Group on October 21, 1976, and the $1,869,500 purchase price being seriously negotiated between G & G Investors and the Gardner Group prior to the sale by it of the property to Jackson-Harris.

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[5] In addition to orchestrating the entire tax shelter scheme and benefiting financially from it, Harris was counsel for all petitioners in this case. He was called as a witness at the trial by respondent.

Nevertheless, petitioners would have us believe that the property which Jackson-Harris purchased in an arm's-length transaction on October 21, 1976, for $1,880,000, was in fact worth $2,850,000 ten days later. There is nothing in the record to indicate how such a dramatic change could have occurred in 10 days' time.

In *Ambassador Apartments, Inc. v. Commissioner*, 50 T.C. 236, 243 (1968), affd. 406 F.2d 288 (2d Cir. 1969), we characterized as "dramatic" a 26-percent increase in the value of an apartment building and land over the period of year. Surely, a 65-percent increase over a span of 10 days is even more dramatic, and on these facts, lacking any semblance of reality. See *Odend'hal v. Commissioner*, 80 T.C. at 612; *Thompson v. Commissioner*, 66 T.C. 1024, 1051 (1976), affd. 631 F.2d 642 (9th Cir. 1980). As we stated in *Grodt & McKay Realty, Inc., supra*:

> Since a normal attribute of a true arm's-length sale is a purchase price at least approximately equal to fair market value, the totally disproportionate purchase price in this instance strongly militates against petitioners' contention that a true sale has taken place. [77 T.C. at 1240–1241; citations omitted.]

Equally detrimental to petitioners' contention that a sale took place between World Realty and Monterey Pines Investors is the treatment of the transaction by the parties completely inconsistent with any hypothesis that Monterey Pines Investors actually owned the property. The record establishes that between October 21, 1976, when Jackson-Harris purchased the property, and July 1983, when the property was sold to Fidelity, Jackson-Harris or Harris himself controlled and used the property at will and for his own benefit.

The property served as collateral for several loans to either Jackson-Harris or Harris, Bagdasarian (Harris' law partner), or both. On June 15, 1978, Valley Radiology Medical Group, Inc. Pension and Profit Sharing Trust loaned $300,000 to a party other than Monterey Pines Investors, taking the property as security. On July 6, 1978, and again on October 26, 1978, the Union Bank of Bavaria loaned $400,000 secured by the property. The proceeds from each of these loans inured to the benefit of Jackson-Harris or Harris, Bagdasarian, or both. Thus, despite petitioners' contention that the property was owned by Monterey Pines Investors in 1978, Harris and his colleagues, and not Monterey Pines Investors, were using the property to secure loans. In this connection, it is noteworthy that only Jackson-Harris ever obtained title insurance on the property.

In 1979 and 1980, the individual petitioners were "cashed out" at an amount equal to their capital contributions plus 10 percent per annum simple interest. No appraisals were made at the time to determine the value of the investors' interests. Rather, the individual petitioners were cashed out at the urging of Ozenbaugh or Harris, for the terms as specified.

Subsequently, Monterey Pines Partners, whose general partner was Ozenbaugh, allegedly purchased the property for $4,001,000 and immediately leased it back to Harris. When the property was sold to Fidelity in 1983, the contract of sale was executed by Fidelity and Jackson-Harris. And as noted earlier, the chain of grant-deeds necessary to transfer legal title completely ignored any interest held by World Realty or Monterey Pines Investors.

Of final significance with respect to the treatment of the transaction by the parties thereto is the complete disregard of the terms of the Purchase and Sale Land Contract. The November 1, 1976, agreement states that during 1977, interest only in the amount of $23,750 per month ($285,000 per year) would be paid to World Realty. However, no cash was ever paid to World Realty by Monterey Pines Investors. Instead, Monterey Pines Investors made payments of $410,929.67 during 1977 to cover the obligations owed by Jackson-Harris to the Bank of America and the Gardner Group. The amount was not only more than that required to be paid by the November 1, 1976, agreement, but instead equaled the $266,997 owed to the Bank of America and the $143,932.80 ($11,994.40 per month) owed to the Gardner Group by Jackson-Harris.

The apportionment of the payments between interest and principal demonstrates further disregard of the terms of the agreement. The November 1, 1976, agreement provides for annual interest payments totaling $285,000 with no payment of principal. Instead, Monterey Pines Investors reported interest deductions of only $233,333 in 1977, of which $225,983 was attributed to the payments totaling $410,929.67. The balance was attributed to principal owed to World Realty.

We note that the discrepancy between the contract terms and the accounting entries of the parties was originally even more disparate. The initial journal entry reflected interest expense of $160,929.67. However, an adjusting journal entry to the books of Monterey Pines Investors made December 31, 1977, credited the Note Payable, World Realty account by an additional $65,053.53 and debited the interest expense account by the same amount, so that the books reflected total interest expense of $225,983.20 for 1977. However, there still remained a $59,016.80 shortfall between the $285,000 required by the agreement and the adjusted figure shown on the books. Needless to say, neither the justification for the adjustment nor the reason for the discrepancy is explained in the record.

Consistent with the disregard shown the November 1, 1976, contract is the concurrent disregard of the October 25, 1976, agreement. According to the October 25, 1976, agreement, World Realty was required to pay Jackson-Harris the amount owed by Jackson-Harris on the October 21, 1976, contract and an amount sufficient to pay off the Bank of America loan. The balance of $300,000 was to be paid in 10 yearly installments with no principal payments until January 1982. Interest was payable at 5 percent for the first 5 years, and at 10 percent, thereafter. In effect, World Realty would step into the shoes of Jackson-Harris in terms of the underlying obligations and also pay Jackson-Harris $300,000 plus interest.

Since the terms of the October 21, 1976, contract called for interest only in the amount of $143,932.80 ($11,994.40 per month) with the balance of $1,635,600 due on or before November 1, 1981, the Jackson-Harris books should have reflected interest income from World Realty in the amount of $175,929 and a reduction in principal of $250,000. The $175,929 interest consists of $143,932 payable to the Gardner Group, $16,997 payable to the Bank of America, and $15,000 payable to Jackson-Harris. The $250,000 principal represents the Bank of America loan.

Instead, Jackson-Harris originally made entries in its books and records reflecting receipt of $217,650.56 interest income from World Realty in 1977, and a reduction of principal due from World Realty of $193,279.11. However, the return filed for Jackson-Harris for 1977 reflects only $114,625 interest income from World Realty, and a reduction in principal amount due from World Realty of $296,305. As we have already noted, the books and records were changed to comport with the figure stated in the return.

We recognize that merely because the transaction does not constitute a sale, it does not necessarily follow, ipso facto, that the transaction is a sham. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981); see *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975), affd. 544 F.2d 1045 (9th Cir. 1976) (purported sales were not sales but options). Further inquiry must be made to determine whether the transaction was entered into without any economic, commercial, or legal purpose other than the hoped for favorable tax consequences flowing therefrom. 77 T.C. at 1243.

Here, petitioners' lack of interest in (1) verifying that the property was actually being acquired and, if so, at fair market value; (2) protecting their acquired interest by way of title insurance and recordation; (3) asserting control over the subject property; and (4) determining that their interests were being disposed of at a fair price, compels the conclusion that the requisite minimum business purpose is absent.

Petitioners' reliance on *Grodt & McKay Realty, Inc. v. Commissioner, supra*, to support their contention that World Realty actually sold the property to Monterey Pines Investors completely misconstrues the law of that case. As detailed above, the facts analysis of *Grodt & McKay* when applied to the facts and circumstances of this case undermines, rather than supports, petitioners' position.

On brief, petitioners express bewilderment at respondent's refusal to accept the validity of the November 1, 1976, Agreement of Purchase and Sale Land Contract as well as his refusal to accept petitioners' justification for their failure to adhere to the terms therein. Petitioners contend on brief that under California law as it it existed between 1974 and 1975:

> The legal community * * * was forced to use the installment land contract because it was the only legally certain protection against losing a low interest loan secured by a trust deed with a due on sale clause.
>
> * * * Any California lawyer would be grossly negligent and incompetent if he did a grant deed rather than an installment land contract.

Petitioners further contend that after executing the alleged land contracts, the unforeseen lis pendens which arose as a cloud on the title resulting from a lawsuit instituted by G & G Investors against the Gardner Group compelled petitioners to deviate from the terms of the contract.

Again, petitioners' argument lacks logic. First, it is unnecessary that we accept or reject petitioners' representation regarding the validity of the installment sale land contract as a proper mechanism for transferring equitable title to property, since, in any case, the installment sale land contract in question was a sham. Moreover, we fail to see how a subsequent cloud on title would cause petitioners to pay more than the amount required by the terms of the contract. If anything, common sense dictates that an amount less than that required would have been warranted under the circumstances.

In sum, considering the totality of the facts and circumstances surrounding the purported sale transactions, we conclude that petitioners engaged in the expedient of drawing up papers to characterize the transactions in question as something contrary to the economic realities thereof, solely to obtain unallowable tax benefits. What pretended to be a sale was really a loan by the individual petitioners to Harris or his nominee, on which 10-percent annual interest was ultimately paid. Petitioners had no interest in the property, which at all times remained under the dominion and control of Harris. In short, what we have before us is in substance a sham, the expected tax benefits of which will be disregarded.

Since we have held that the Monterey Pines Investors' alleged holding of the property was a sham, there is no basis for holding that the limited partnership was liable under section 1442 for withholding tax on its purported interest payments, which in no event went to World Realty, or for the section 6651(a) addition to tax for the partnership's failure to file Form 1042. The payments were merely the application by Harris of funds which he at all times controlled, without legal significance insofar as this case is concerned.

Constructive Dividends

Michael and Marilyn Falsetti (the Falsettis) purchased the building, inventory, and equipment of Farnesi's Restaurant. The restaurant was operated as a sole proprietorship from January 1976, until August 3, 1976, when the business was incorporated. The inventory and equipment were transferred to Mikomar. The Falsettis were the sole shareholders and corporate officers of Mikomar.

During 1977 and 1978, Mikomar paid certain amounts related to auto, boat, travel, insurance, and certain other unidentified expenses. Respondent determined that such payments were personal expenses of the Falsettis and therefore constituted constructive dividends to them. Respondent has assessed the amounts deducted by Mikomar, and the record does not indicate that Mikomar has sought a refund of tax based upon the assessment. Respondent seeks to have the amount paid by Mikomar taxed as constructive dividends to the Falsettis.

The Falsettis concede that the amounts paid by Mikomar pertaining to the Continental Mark V and the Pantera are constructive dividends to them. However, the Falsettis contend that all other expenses at issue were ordinary and necessary business expenses of Mikomar.

The Commissioner's determination in his statutory notice of deficiency is presumptively correct, and the Falsettis, as petitioners, bear the burden of disproving each individual adjustment. Rule 142(a). It is well established that where corporate property is used by a shareholder or member of his family for personal purposes, not proximately related to the corporate business, the corporation is not entitled to deductions to the extent that they relate to such personal use, and the fair rental value of such property is includable in the shareholder's income as constructive dividends to the extent of the corporation's earnings and profits. *Commissioner v. Riss*, 374 F.2d 161, 166–167, 170 (8th Cir. 1967), affg. a Memorandum Opinion of this Court on this issue but revg. and remanding on other issues.[6] Likewise, payments made for the personal benefit of a shareholder by a corporation may constitute constructive dividends. *Challenge Manufacturing Co. v. Commissioner*, 37 T.C. 650, 663 (1962).

The Court of Appeals for the Ninth Circuit, to which an appeal of this case would lie, has enunciated a two-part test for resolution of the constructive dividend issue. That Court has held that the fact that corporate payments are not deductible does not automatically result in constructive dividends to a shareholder. *Palo Alto Town & Country Village, Inc. v. Commissioner*, 565 F.2d 1388, 1391 (9th Cir. 1977). The test for constructive dividends in such circumstances is twofold: not only must the expenses be nondeductible to the corporation, but they must also represent some economic gain or benefit to the shareholder. 565 F.2d at 1391. Thus, where a corporation makes a distribution to a shareholder which serves no legitimate corporate purpose and which results in an economic benefit to the shareholder, such benefit constitutes a constructive dividend to the shareholder to the extent of earnings and profits. *Palo Alto Town & Country Village, Inc. v. Commissioner*, 565 F.2d at 1391; *Commissioner v. Riss*, 374 F.2d at 167. This rule was also applied by the Ninth Circuit in *Meridian Wood Products Co. v. Commissioner*, 725 F.2d 1183, 1191 (9th Cir. 1984).

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[6] See also *Whipple Chrysler-Plymouth v. Commissioner*, T.C. Memo. 1972–55.

Often the Court will have before it both the individual shareholder and the corporation so that application of the two-part test is a relatively simple matter. However, Tax Court jurisdiction is dependent upon timely filed petitions by both the individual shareholder and the corporation. Thus, as in this case, application of the Ninth Circuit's constructive dividend rule is complicated when only one of the parties is before the Court, a circumstance beyond our control. Nevertheless, mindful of the Ninth Circuit's mandate that we make specific findings of fact with respect to each element, we proceed as best we can on the record before us.

With respect to the Blazer, we have found that the vehicle was utilized for both business and personal use. Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." It is incumbent upon petitioners to keep records sufficient to enable the Commissioner to correctly determine the income tax liability. Sec. 6001; see sec. 1.162–17(d)(2), Income Tax Regs. Here, petitioners have failed to keep any records whatsoever pertaining to the alleged business use of the Blazer.

However, where the court is convinced that legitimate business expenses were actually incurred by petitioners, we may, under appropriate circumstances, approximate the amount of expenses petitioners are entitled to. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930). We accept petitioners' testimony to the extent that a part of the use of the Blazer was for business. Petitioners used the Blazer to pick up wine for the restaurant 1 to 3 times a month from Sangor, California, which is approximately 50 to 60 miles from the restaurant. Petitioners also drove to Fresno, which is approximately 40 miles from the restaurant, to pick up supplies for the restaurant. Moreover, petitioners have conceded that the Lincoln and the Pantera were their personal vehicles, thus lending credence to their testimony that the Blazer was a business vehicle.

On the other hand, the Blazer was also used by petitioners while on vacation to tow boats to various recreational lakes in California and to commute the short distance of 1 mile between home and the restaurant. Taking into account all the facts and circumstances surrounding the use of the Blazer, we hold that 75 percent of the use of the Blazer was for legitimate business purposes. Consequently, 75 percent of the expenses attributable to the Blazer and paid by Mikomar do not constitute constructive dividends to the Falsettis. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

With respect to the travel and boat expenses, the Falsettis have failed to meet their burden of proof. In order to deduct expenses for travel or entertainment, the Falsettis must meet the strict substantiation requirements of section 274(d). Section 274(d) requires that a taxpayer substantiate by adequate records or sufficient evidence corroborating his own testimony for each deducted item: (1) The amount; (2) the time and place of the travel or entertainment; (3) the business purpose of the expense; and (4) the relationship between the taxpayer and the person entertained.

The Falsettis have failed to meet any of the substantiation requirements of section 274(d) and therefore we agree with respondent that Mikomar would be precluded from claiming any deductions relating to the travel and boat expenses. Since the corporate expenditures were for the personal benefit of the Falsettis, they are taxable on the amount thereof.

During the fiscal year ended October 31, 1977, Mikomar paid premiums totaling $373 on health and life insurance policies in which Michael Falsetti was named as the insured. The Falsettis introduced no evidence to support a claim that the premiums were not for their personal benefit, and we accordingly sustain respondent's determination that the premiums are taxable to the Falsettis in 1977. Rule 142(a).

Finally, with respect to the unidentified expenses, the Falsettis have failed to establish that the amounts paid by Mikomar had any business purpose whatsoever, or that the payments were not for their benefit. Consequently, respondent's determination that the expenses were not deductible is upheld. Rule 142(a).

To reflect the foregoing,

Decisions will be entered for the respondent in docket Nos. 5437-83 and 5438-83.

Decisions will be entered under Rule 155 in docket Nos. 7013-82 and 7111-83.

Decision will be entered for the petitioner in docket No. 20833-83.

DAYTON W. ADAMS, JR., AND SHELLEY A. ADAMS, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 922–82. Filed August 22, 1985.

Former counsel for petitioners agreed on their behalf that they would be bound by the result in other cases involving an issue in this case. Thereafter petitioners moved to be relieved of the agreement on the grounds that counsel was not authorized to enter into it and that he had a conflict of interest. *Held*: Petitioners' motion is denied. No cognizable prejudice was shown.

David E. Weiss, *Howard J. Kalson*, and *Donald W. Geerhart*, for the petitioners.

Terence D. Woolston and *Fera Wagner*, for the respondent.

COHEN, *Judge*: Petitioners have asked the Court to relieve them of a settlement agreement in which they agreed to be bound by the result in the cases of *Anderson [and Clawson] v. Commissioner*, 83 T.C. 898 (1984), on appeal (9th Cir., Mar. 5, 1985) (*Anderson*). Petitioners claim that the attorney who entered into the agreement on their behalf was not authorized to do so and had a conflict of interest by reason of his prior representation of the promoter of the tax shelter in which they invested.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulation is incorporated herein by this reference. Petitioners were residents of Arizona at the time they filed their petition herein. Dayton W. Adams, Jr. (petitioner), entered into the transactions about which the dispute in this proceeding arises.

Operative Facts

In 1978, petitioner was a senior investment salesman for Coldwell Banker & Co. (Coldwell Banker). Petitioner had his own clients and conducted his business as if in partnership with Coldwell Banker. He was in the top 20 income-producers for the company and earned in excess of $200,000 in that capacity in 1978. Subsequent to 1978, petitioner became a partner in a major real estate development firm in Arizona with responsibility for acquisitions and dispositions of income-producing real estate. He thus had substantial business experience at all times material to this proceeding.

In March 1978, petitioner attended a seminar on investments sponsored by Coldwell Banker. The speaker at the seminar was Wayne A. Smith (Smith), a Phoenix attorney. Smith discussed various tax-advantaged investment opportunities. Smith stated that the best tax-oriented investment he had seen was being organized in Nevada by a geologist by the name of Einar C. Erickson (Erickson). The Erickson program described at this meeting involved acquisition of mining claims, called A & B claims, and subsequent donation of the claims to a charity (the charitable contributions program). At the end of the seminar, petitioner met with Smith to discuss further the investments and petitioner's tax situation. Smith recommended that petitioner also speak to Gregory Davis (Davis), an accountant with knowledge of the Erickson program.

After several meetings, Smith and Davis encouraged petitioner to become a participant in the charitable contributions program and in another Erickson program referred to as the

"Diamond Mine Project." Smith and Davis represented that they individually were participants. Petitioner was aware that Smith, as counsel for Erickson, wrote the tax opinion contained in the Diamond Mine Project offering memorandum and prepared the contractual documents executed by participants in that program. He specifically raised with Smith the question of conflict of interest and was told by Smith that there was none. Smith also told petitioner that he could disregard the "boilerplate" disclaimers in the offering memorandum. Petitioner also contacted third persons before investing in the Erickson programs.

Petitioner acquired an interest in A & B claims and, in December 1978, became a participant in the Diamond Mine Project. His participation was reflected in agreements identical to those described in *Anderson*, 83 T.C. at 900–904. Briefly, those documents were (1) an agreement under which Erickson was to locate and stake for petitioner a mining claim and to perform services in relation thereto that would be deductible under section 616,[1] dealing with development expenses, and (2) a mining contract with Silver Viking Corp., a corporation owned by Erickson, dealing with ore to be extracted from the claim to be located and staked for petitioner by Erickson. (We found in *Anderson* that those agreements expressly negated any joint venture between participants and Erickson, and they gave participants no interest in any mining property prior to the staking of a new claim on their behalf.) Petitioner gave Erickson a $30,000 check and a nonrecourse note for $120,000 for 1½ units in the Diamond Mine Project.

On their tax return for 1978, petitioners deducted $150,000, as "development expenses" relating to the Diamond Mine Project, on Schedule C. They also deducted $15,000 as "exploration expenses," in relation to the A & B claims, on Schedule A.

In June 1979, petitioner invested in another program promoted by Erickson and Davis, referred to as the "Gila Mining Project." Smith had also prepared the offering memoranda and associated documents on the Gila Mining Project.

Petitioner visited the Diamond Mine site in Nevada on several occasions during 1979 and through May 1980. In late

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years here in issue.

1979, information came to petitioner's attention that caused him to have doubts about Erickson and Davis. He was surprised to discover that on or about November 7, 1979, a Certificate of Location of Lode Mining Claim had been filed on behalf of certain participants in the Diamond Mine Project, including himself. He inquired of Erickson and Davis about the purpose of the claim and was told that it was part of the Diamond Mountain, an area larger than the Diamond Mine Project. See *Anderson*, 83 T.C. at 905. In or about June 1980, petitioner learned that Erickson had entered into an agreement with third persons under which the third persons would receive 50 percent of the production of the Diamond Mine. Because he believed that under the mining contract with Silver Viking Corp. he and other participants in the Diamond Mine Project owned 50 percent of the production of ore from the Diamond Mine, and Erickson owned 50 percent of the production, petitioner confronted Erickson.

On or about July 29, 1980, petitioner and Erickson, on behalf of Silver Viking Corp., entered into two writings entitled "Points of Understanding" and "Addendum to Mining Contract," in which they agreed that petitioner had a 3.2786885 percent of 50-percent interest in the net production of the Diamond Mine. Those documents were the conclusion of protracted negotiations between petitioner and Erickson. According to petitioner, the purpose of the documents was to clarify petitioner's right to production of ore from the entire Diamond Mountain, to give petitioner a right to inspect various accounting materials and reports of production, and to protect him and other participants from the claims of third persons in the production from the mine. (See *Anderson*, 83 T.C. at 905.) The Addendum to Mining Contract was clarified by a minor correction in a document dated August 5, 1980.

At the end of August 1980, petitioner attended a meeting of the Gila Mining Project investors. At that meeting, Davis stated that Erickson had misappropriated between $400,000 and $1,400,000 from the Gila Mining Project, and that Erickson was incompetent and had never successfully performed a venture in his life. Petitioner met again with Davis in September and October 1980. Smith was also present at the October meeting. At that time, Davis made statements to Smith in petitioner's presence regarding embezzlement of funds by Erickson. In November 1980, petitioner again met with Smith and Davis. At that meeting, according to Adams' testimony:

> Davis disclosed that the Diamond Mine Project had been completely his idea; that he and Erickson had been flying over Nevada and saw the old mine down below, and he suggested that they put together an investment group to do the mine, and that that was the full extent of any geological due diligence that was done on the property.
>
> Q. Excuse me, I didn't hear whether you covered the question. Was any statement made with regard to geological studies of ore reserves?
> A. Yes.
> Q. What was that statement?
> A. That there were no studies.

In November 1982, Erickson was indicted on charges arising out of the charitable contributions program. In the fall of 1984, he was acquitted of those charges.

Tax Court Litigation

In the fall of 1980, petitioner contacted a law firm in Phoenix with respect to pursuing litigation against Davis, Erickson, and Smith. He sued Davis, but that suit was abandoned after a motion for summary judgment was denied. He did not sue Erickson or Smith.

Petitioner consulted with a tax lawyer at the Phoenix firm, David E. Weiss (Weiss). Weiss declined to represent petitioner in relation to the tax claims because he concluded that it would be a waste of time and money. In October or November 1980, petitioner and Weiss had a telephone conversation with Smith concerning the tax aspects of petitioner's investment in the Diamond Mine Project. Smith advised petitioner and Weiss that Smith was going to pursue his tax remedies, and that petitioner would be able to use Smith's case as a test case. Smith proposed that petitioner pay his pro rata share of out-of-pocket expenses of the litigation. Weiss advised petitioner that, if petitioner litigated the tax deductions claimed in 1978 with respect to the Diamond Mine Project, he would lose. However, petitioner, Weiss, and Smith were under the impression that, if Smith lost his test case, petitioner would still be entitled to secure a settlement with the Internal Revenue Service that would allow him to deduct his out-of-pocket expenses. Petitioner and Weiss specifically considered whether Smith had a conflict of interest, based on his prior representation of Erickson, but concluded that petitioner should allow Smith to represent him. On or about November 14, 1980, petitioners executed an Internal Revenue Service Form 2848, Power of Attorney, appointing Smith to represent them. Smith represented petitioners with respect to the audit of their tax returns for the years 1978 through 1980.

On January 12, 1982, Smith filed the petition herein on petitioners' behalf. In that petition, among other things, petitioners alleged:

> During the taxable years 1978 and 1979, petitioners engaged in mining operations for profit and incurred expenses in the amounts of $150,000.00 and $224,000.00, respectively, for the development of a mine in which existence of ores and minerals in commercially marketable quantities had been disclosed.

Those allegations for 1978 related to the Diamond Mine Project, and the allegations for 1979 related to the Gila Mining Project.

On more than one occasion after 1980, petitioner and Weiss discussed with Smith the strategy to be pursued by Smith in litigation in the Tax Court over the tax consequences of the 1978 investment in the Diamond Mine Project. Smith's strategy was to limit the trial to a single issue, to wit, the issue set forth in the statutory notice and in the petition as to whether or not the amount claimed was paid "for the development of a mine in which existence of ores and minerals in commercially marketable quantities had been disclosed." Smith believed that he could prevail on that issue and that respondent's counsel would not raise any additional issues. Weiss believed, and advised petitioner, that petitioners would lose on any other issue.

During 1981, 1982, and 1983, Smith filed 16 petitions with respect to the deductibility of amounts purportedly paid in 1978 for "development expenses" of participants in the Diamond Mine Project. Such petitions were filed on behalf of petitioners herein, Smith, Morris E. Anderson and Marlene H. Anderson (Anderson), and Robert K. Clawson and Shirley S. Clawson (Clawson), as well as various other participants. Those petitions were grouped with other "Erickson Mining" cases and assigned to a single judge for trial or other disposition.

Cases involving Erickson's charitable contributions program, in which taxpayers were represented by counsel other than Smith, were set for trial in Los Angeles, California, on January 4, 1984. Those cases in which taxpayers were represented by Smith were not consolidated with the cases set for trial in Los Angeles and, to that time, no arrangements had been made by which petitioners represented by Smith would be bound by the outcome in the cases set in Los Angeles. Nonetheless, on October 21, 1983, Smith filed a motion for severance and consolidation as separate group on behalf of those taxpayers represented by him, including petitioners. In that motion, Smith stated:

> 2. Each petitioner is an owner of a separate mining claim located within said mining districts in Eureka County in the State of Nevada.
>
> * * * * * * *
>
> 5. The sole issue in each of the cases set forth above is the deductibility of mining, exploration and development expenses relating to those mining claims which issue is separate and apart from any other cases in which Einar C. Erickson is involved.
>
> 6. The case of each petitioner contains identical issues of fact and law which can be handled most economically and expediently through severance and consolidation of these cases from the cases containing unrelated issues.
>
> * * * * * * *
>
> 8. Petitioners will be subject to unnecessary expense and attorney fees as a result of the other unrelated cases containing different and separate issues not involved in the above-captioned cases.
>
> 9. Petitioners will be subject to delay and unfair prejudice as a result of the issues contained in the other cases consolidated with the above petitioners.
>
> 10. Petitioners have retained the undersigned counsel to represent them regarding the deductibility of their mining expenses with which counsel for petitioners is intimately familiar.
>
> 11. Counsel for petitioners represents each member of the Diamond-Excelsior and Silverado-Diamond mining claims and the Court will not be required to deal with different and various counsel with regard to the said claims.

The motion for severance was heard in Phoenix, Arizona, on December 6, 1983. Pertinent portions of the transcript of the hearing are as follows:

THE CLERK: Docket number 13707-81 and related docket numbers, Gennaro Licosati and Margaret Licosati and related petitioners.

MR. SMITH: Wayne Smith, for the Petitioner, Your Honor.

MR. JOHNSON: Robert A. Johnson for Respondent.

THE COURT: Good morning, gentlemen.

I understand yesterday you had a solution to these cases.

MR. JOHNSON: Yes, Your Honor. What we have pretty much agreed to do is because some of the cases are just the development and the exploration expense issue, others are involved with other types of shelter investments and other issues and some of them involve the charitable contribution issue, which I understand you're hearing some cases over in Los Angeles in January, we've agreed to take one or two or a few of the representative samples of the clean cases and just proceed to trial with those and agree between the parties that the other cases on this issue will be bound by the results in those cases.

THE COURT: That's good. That is what I was going to suggest.

Now, when do you think you can have them ready for trial?

MR. SMITH: We're ready now, Your Honor.

If Your Honor is aware, I did file a motion to calendar these cases for January.

THE COURT: Well, we can't put them on the January calendar.

MR. SMITH: I'm aware of that, but I would like to expedite the trial in this case. I don't feel that the taxpayers' best interests are being served by letting these cases drag on.

* * * * * * *

THE COURT: I'm not sure at this point whether those cases are going ahead in January. We have had some problems with discovery in those cases and it may be necessary to continue them and I'm very anxious to have some of these cases tried too, because there are a lot of petitioners filing additional petitions and I think the issue should be resolved for their benefit.

It's just not feasible to set it upon demand by one party rather belatedly made. That's the problem.

MR. SMITH: Some of these cases are scheduled for an April calendar in Phoenix, Your Honor. I'm not sure which ones.

* * * * * * *

THE COURT: Then I would think based on my experience in Los Angeles that it would take you that long to work out a stipulation whereby all of your clients agreed to be bound by the results in those cases.

MR. SMITH: Well, I'm in control of all of my clients and I don't anticipate the problems that you're having in Los Angeles, Your Honor.

* * * * * * *

THE COURT: * * * Mr. Smith, do you need Mr. Erickson's testimony in relation to your cases?

MR. SMITH: Yes, it would be helpful, but it is not imperative. We would be willing to proceed without Mr. Erickson.

THE COURT: All right, you understand the situation now. I assume that respondent's counsel doesn't need Mr. Erickson.

MR. JOHNSON: No, ma'am.

On the basis of the foregoing, the *Anderson* and *Clawson* cases were set for trial in Phoenix commencing April 25, 1984. At the time of trial, an agreement for settlement was filed whereby Smith agreed, on behalf of taxpayers represented by him other than Anderson and Clawson, to be bound by the result in the *Anderson* and *Clawson* cases "on the issue set forth in the pleadings and the notice of deficiency as determinative of the proper treatment of the development expenses, with respect to the Silverado claims." (See *Anderson*, 83 T.C. at 906.) This agreement was consistent with the trial strategy agreed upon among Smith, petitioner, and Weiss.

On April 5, 1984, Smith wrote a letter to petitioners in which he stated "As you are aware, the Tax Court has set the 'Diamond Mine' case for trial in Phoenix, Arizona, commencing April 25, 1984." Smith requested a contribution of $1,000 per claim to defray the legal fees and costs attributable to the trial and stated:

> Investors who do not contribute by April 25, 1984 will not be represented by me in the trial of the case and the Internal Revenue Service will not be bound by the Court's decision as it relates to that investor's claimed deduction.
>
> If you have any questions regarding the contents of this letter or the trial, please contact me.

Petitioner received the letter from Smith, but he made no response to the letter. On June 11, 1984, Smith filed a petition in this Court's docket No. 17805–84, on behalf of petitioners with respect to the taxable year 1980.

On August 27, 1984, Smith wrote another letter to petitioner. That letter stated as follows:

> As you are aware, the "Diamond Mine" case was tried before the U.S. Tax Court during April. I have recently filed an opening brief on behalf of the petitioners, a copy of which is enclosed for your information.
>
> As I explained in my letter to you of April 5, 1984, trying this case was expensive and time consuming. The legal fees and out-of-pocket expenses accrued in this matter through July 31, 1984, total $18,672.64. A detailed statement which itemizes the fees and costs is enclosed. I am requesting that

> each investor contribute his pro-rata share of said fees and costs. I have represented investors owning 13.5 "Diamond Mine" claims and, therefore, each investor's pro-rata share is $1,383.16 per claim. Since you are the holder of one and one-half claims, your share of the legal expenses is $2,074.74. We have received no payments from you in response to our previous request. Please remit $2,074.74 as soon as possible, as I will not be able to continue to represent those investors who do not pay their share of these expenses.
>
> If you have any questions regarding this letter or the trial, please do not hesitate to contact me.

Upon receipt of that letter, petitioner contacted Weiss.

Petitioners learned no later than October 1984 that Smith had entered into the agreement for settlement. Petitioner obtained a copy of respondent's brief in *Anderson* and provided it to Weiss. Weiss became concerned on reading that brief, particularly because of the discussion of the failure of Anderson or Clawson to conduct any investigation into the bona fides of the Erickson program. Petitioner was advised to consider suing Smith for malpractice, but he did not do so. Smith was still representing petitioner in his mining investment tax matters.

In late November or early December 1984, Weiss called the Court and orally expressed an intention to bring a motion to be relieved of the settlement agreement. Weiss was advised to await the opinion of the Court in *Anderson*, which was filed December 5, 1984.[2]

On February 4, 1985, petitioners filed the motion for relief from agreement for settlement that we are considering here. In that motion, they allege that Smith was not authorized to enter into the agreement for settlement, and that they were unaware of the terms thereof and not given an opportunity to authorize or reject them. Petitioners further allege that Smith did not represent their interests because of his conflict of interest, i.e., his prior representation of Erickson and his "prominent role in inducing the petitioner to invest in the project." They claim that because of this conflict of interest, Smith failed to raise an alternative theft-loss issue for 1979 or 1980.

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[2] This fact is set forth only to avoid any implication that petitioners decided to bring the motion only after the Court's ruling in *Anderson*.

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OPINION

In their post-hearing brief, petitioners describe the purpose of their motion as follows:

> At the conclusion of the hearing [of the motion], the Court inquired whether petitioners intend to relitigate the issues decided in the Anderson and Clawson cases if the instant motion is granted. Petitioners hereby reiterate the representation made by the undersigned in open court that they have no such intention. Their exclusive motivation and intention is to secure the same settlement terms from respondent which would be available to any similarly situated taxpayers who invested in tax shelters in 1980 or prior years and have not yet tried their cases. * * *

Petitioners ask the Court to relieve them from the agreement entered into by their counsel of record and, in effect, to reinstate a claim that they do not intend to litigate. Even if we had the authority or power to impose a settlement position on a party, we find no equity in this case that would justify exercise of that authority or power.

Petitioners have also stated the issue as:

> The ultimate issue to be resolved in ruling on this motion is whether the client who authorizes an attorney to file a Tax Court petition can and should be held accountable for any actions thereafter taken by the attorney in such case regardless of whether those actions violate the A.B.A. Code of Professional Responsibility and thus Rule 201(a) of the Court's Rules of Practice.

We think that this statement is overly broad, and we decide only whether Smith had authority to enter into the agreement in issue; whether his apparent conflict of interest is a ground for relief from that agreement; and what criteria should be used in ruling on a motion to be relieved of such an agreement.

Authority

The term "agreement for settlement" in this case is essentially a misnomer, because the agreement did not settle or compromise petitioners' claim but merely prescribed a procedure whereby that claim would be adjudicated. Smith, as attorney of record, had full authority to decide on procedural steps to be taken in the litigation. Long ago the Supreme Court said:

> When an attorney has been retained he has certain implied powers to act for his client, in a suit actually commenced, in the due and orderly conduct of the case through the courts. In cases of suits actually pending he may agree that one suit shall abide the event of another suit involving the same question, and his client will be bound by this agreement * * * [*Stone v. Bank of Commerce*, 174 U.S. 412, 422 (1899).]

See 7 Am. Jur. 2d, Attorneys At Law, secs. 149–150, at 206–207 (1980).

Because of the label attached to the agreement in this case by the parties, however, we will assume that this is not a case where authority would be implied. We will, therefore, make a factual determination of whether Smith was acting within the scope of his actual or apparent authority. See *Harrop v. Western Airlines, Inc.*, 550 F.2d 1143 (9th Cir. 1977); *Arizona Title Insurance & Trust Co. v. Pace*, 8 Ariz. App. 269, 445 P.2d 471 (1968).

Petitioner, after consultation with Weiss and express consideration of a possible conflict of interest and with knowledge that his tax claims probably had no merit, employed Smith to represent him in the audit of the years 1978, 1979, and 1980, and to file two petitions in this Court. To the extent that petitioner, Weiss, and Smith purported to agree that petitioners' case would be held in abeyance and never be tried because of the doubts as to its merit, they would be agreeing to limit the authority Smith would normally have as counsel of record. Such agreement would seem to abuse the process of this Court, to usurp the Court's control over its calendar, and otherwise to be contrary to sound public policy.

> The administration of justice is not a subject to be controlled by contract, and the courts are agreed that agreements which have a tendency to obstruct, impede, or interfere with the administration of justice are contrary to public policy. All agreements relating to proceedings in the courts, civil or criminal, which may involve anything inconsistent with the full and impartial course of justice therein are void, even though they are not open to the charge of actual corruption. This is true regardless of the good faith or intent of the parties at the time the contract was entered into, or the fact that no evil resulted by or through the contract. In other words, all agreements for pecuniary consideration to control the regular administration of justice are void as against public policy, without reference to the question whether improper means are contemplated or used in their execution. Such agreements are evil in their tendency and therefore it is the policy of the law to discourage them by consistently holding them void. [17 Am. Jur. 2d, Contracts, sec. 193, at 563–564 (1964); fn refs. omitted.]

See also 7 Am. Jur. 2d, Attorneys At Law, sec. 196, at 246 (1980). Such an agreement is certainly not one that we would readily enforce.

In any event, from the evidence it appears that the agreement entered into with respondent by Smith was consistent with the strategy chosen by petitioner, Weiss, and Smith. They originally discussed a "test case" procedure, although Smith may have indicated that his own case would be the test case. Smith later moved to set all cases, including petitioners', for trial in January 1984, a step that was within his apparent authority as counsel of record. He expressly represented that he had "control of [his] clients" in dealing with the Court and with respondent, and petitioners clearly put him in the position to make those representations.[3]

Moreover, petitioners were put on notice by Smith's letters of April and August 1984, although not necessarily completely or accurately, of the procedures that had been adopted. It was not the procedure that caused them to make the present motion, but what Weiss read in respondent's brief about the testimony given at trial of the *Anderson* and *Clawson* cases. At this point, they decided that Smith had used poor judgment in choosing the "test cases" because neither Anderson nor Clawson had independently investigated the Erickson ventures to the extent that petitioner in this case had. Such investigation, however, had no bearing on the issue to which the trial was, according to their strategy, to be limited, i.e., the existence of ores in commercially marketable quantities. We infer that after reading respondent's brief, petitioner and Weiss merely realized that Smith had not been effective in the strategy voluntarily adopted among petitioner, Smith, and Weiss. Only then did they do anything to advise respondent's counsel or the Court that Smith purportedly lacked authority.

Thus we conclude that Smith had actual and apparent authority to enter into an agreement in all material respects equivalent to the agreement for settlement in issue here. Even if he did not have actual authority, his actions would be

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[3] We find incongruous petitioners' present contention that we should act to relieve petitioners of the consequences of their employment of counsel because Smith is "an officer of the Court." His responsibility to the Court is something that may be dealt with in an appropriate proceeding. Petitioners, however, are "in pari delicto" to the extent that any misconduct by Smith was known to and consented to by them.

binding on petitioners. *Arizona Title Insurance & Trust Co. v. Pace, supra*. See *Senate Realty Corp. v. Commissioner*, 511 F.2d 929, 932–933 (2d Cir. 1975); *Brooks v. Driscoll*, 114 F.2d 426, 428–429 (3d Cir. 1940). Cf. *Flood v. Commissioner*, 468 F.2d 904 (9th Cir. 1972).

Conflict of Interest

Petitioners contend that Smith was precluded from acting on their behalf because of the conflict of interest arising out of his prior representation of Erickson and his own involvement in preparing the documents used to reflect petitioner's participation in the Erickson program. All of the relevant facts, however, were known to petitioners and to their independent counsel, Weiss, prior to the filing of the petition herein.

Petitioners complain that Smith failed to make a theft loss claim on their behalf in 1979 or 1980 because of his loyalty to Erickson. Assuming that to be true, petitioners' remedy is to move to amend the respective petitions as to those years. As respondent concedes, nothing in the Court's opinion in *Anderson* constitutes a holding as to claims made in years other than 1978.

Smith's apparent conflict of interest arises from his necessity of vindicating himself as to the representations he may have made to petitioners before they entered into the transactions in 1978 as well as from his representation of Erickson in those transactions. See A.B.A. Model Rules of Professional Conduct, rule 1.7(a). Petitioner testified that he believed that he acquired an interest in the Diamond Mine through those agreements drafted by Smith. As we held in *Anderson*, however, those documents did not give him any interest in the Diamond Mine but only an interest in a claim to be staked by Erickson in the future. Petitioner here claims that he was surprised when notified by Erickson in late 1979 that a claim had been staked on his behalf. The express terms of the agreement that petitioner signed, however, were that Erickson would locate a new claim and that there was no joint venture relationship between Erickson and the participants in his program. See *Anderson*, 83 T.C. at 910–911.[4]

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[4] The evidence in this case as to the agreements entered into in 1980 supports the conclusion in *Anderson v. Commissioner*, 83 T.C. 898 (1984), on appeal (9th Cir., Mar. 5, 1985), that self-serving

Alternatively, in defense of his failure to secure for the participants the contractual rights that petitioner thought he had, Smith might assert that the participants were interested only in the desired tax consequences and, therefore, were not damaged by the failure to obtain economic results to which they were indifferent. Thus a defense by Erickson and Smith to potential nontax claims of the participants would necessarily undermine the positions Smith was maintaining on behalf of the participants in this Court.

Petitioners rely on *Wilson v. Commissioner*, 500 F.2d 645 (2d Cir. 1974), revg. a Memorandum Opinion of this Court, in which we were directed to hold an evidentiary hearing in which a taxpayer, seeking relief from a settlement agreement entered into by counsel who had a conflict of interest, might explain her failure to seek the advice of independent counsel. After holding such a hearing, we found that the conflict of interest was unknown to the petitioner. In *Wilson v. Commissioner*, T.C. Memo. 1976–285 (35 T.C.M. 1276, 1278, 45 P-H Memo T.C. par. 76,285, at 1256–76), we stated:

> Ordinarily such naivete would not be sufficient grounds for reopening a case on the basis of lack of adequate representation by counsel. See *Coussement v. Commissioner*, 391 F.2d 227 (6th Cir. 1968), affg. a Memorandum Opinion of this Court; *Chiquita Mining Co. v. Commissioner*, *supra*; *Crane-Johnson Co. v. Commissioner*, 105 F.2d 740 (8th Cir. 1939), affg. 38 B.T.A. 1355 (1938), affd. 311 U.S. 54 (1940). However, in the instant case we are presented with a situation in which petitioner's counsel * * * also represented a co-petitioner * * * whose interests were inconsistent with those of petitioner. * * *

The *Wilson* case is distinguishable on several grounds. Petitioner here was a sophisticated businessman; he had knowledge of the conflict of interest; and he consulted independent counsel. Although petitioner and Weiss testified that they believed there would be no conflict if Smith pursued only his own case, we are unimpressed by this reasoning. Smith's interest was to make arguments, in whatever case, that would promote the Erickson program participants' tax claims while protecting Smith against claims by those who relied on his

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reports rendered by Erickson in 1981 or 1982 were not reflective of the contracts entered into in 1978. It now appears that those reports and evidence of accountings rendered by Diamond-Treasure Hill, Inc., related to the 1980 agreements negotiated when petitioner discovered that he did not have a right to production from the entire Diamond Mountain.

advice. In *Wilson*, the tax positions of the two parties represented by one counsel were irreconcilable in that the husband benefited from one and the wife benefited from another. Here, the *tax* positions of the parties represented by Smith were parallel, if not identical. See generally *Alexander v. Superior Court*, 141 Ariz. 157, 685 P.2d 1309, 1315 (1984). We conclude, therefore, that Smith's conflict of interest is not a ground for setting aside the agreement in this case.

Criteria for Ruling on Motion

Petitioners' present motion was brought before entry of decision in this case and while other related and unrelated issues remained unresolved. Petitioners contend, therefore, that cases in which a Court refused to vacate a final judgment do not provide the relevant criteria. Specifically, they contend that they are not required to show a "fraud on the Court." Respondent does not dispute this contention and agrees that the Court has discretion to set aside the agreement in this case.

Petitioners also contend that the agreement should not be enforced in this case because, according to petitioners, the Court was under the misapprehension that all of the cases dealt with by the agreement for settlement were "clean cases," i.e., cases not involving issues other than deductibility under section 616 of development expenses allegedly incurred in 1978. Petitioners' position on this point is without support in fact or reason.[5] The *Anderson* and *Clawson* cases were selected, as set forth in the above-quoted portions of the transcript of hearing of December 6, 1983, because *they* did not involve issues other than developmental expenses. The obvious implication of those discussions was that other cases were not suitable because they involved other issues, but that progress in resolving issues could be made by the procedure agreed to by Smith on behalf of all of his clients.

Appropriate criteria to apply to petitioners' present motion may be found in cases dealing with attempts to modify a pretrial order under rule 16, Federal Rules of Civil Procedure

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[5] Petitioners' motion and the supporting memoranda contain several misstatements about the procedural history of these cases. We do not, however, attempt to correct each of them.

(FRCP 16).[6] The *Anderson* and *Clawson* cases were set for trial by Court order on the basis of the representations of counsel and the procedure agreed to on December 6, 1983. The purpose of the agreement for settlement, comparable to that of a FRCP 16 order, was to narrow issues for trial and to resolve triable issues in an efficient manner. A FRCP 16 order may be modified "to prevent manifest injustice." The party seeking modification, however, must show that the failure to allow the modification might prejudice him. *Angle v. Sky Chef, Inc.*, 535 F.2d 492, 495 (9th Cir. 1976). Discretion should be exercised to allow modification where no substantial injury will be occasioned to the opposing party; refusal to allow modification might result in injustice to the moving party; and the inconvenience to the Court is slight. *Angle v. Sky Chef, Inc., supra*, quoting *Sherman v. United States*, 462 F.2d 577, 579 (5th Cir. 1972); *Campbell Industries v. M/V Gemini*, 619 F.2d 24, 27–28 (9th Cir. 1980).

The injury to respondent and inconvenience to the Court in reopening the questions tried and decided in *Anderson* are obvious. Cf. *Brooks v. Commissioner*, 82 T.C. 413, 429–430 (1984), on appeal (9th Cir., Dec. 19, 1984). More compelling, however, is petitioners' failure to show that they are prejudiced in any cognizable way.

Petitioners claim prejudice in that respondent now refuses to settle by allowing them a deduction for their out-of-pocket expenses incurred in 1978. They have presented no theory, however, under which they could prevail if that issue were tried. Petitioners claimed that they were entitled to deduct $150,000, consisting of $30,000 in cash and a $120,000 nonrecourse note, under section 616. That section requires a showing that the expenditures be paid or incurred "after the existence of ores or minerals in commercially marketable quantities has been disclosed." We found in *Anderson*, however, that the agreement executed by petitioners in 1978 expressly gave them only a right to have Erickson locate and stake for them a claim. In this case, as in *Anderson*, Erickson performed that service no sooner than 1979. The services described in the agreement were more in the nature of expenses to ascertain the existence, location, extent, or quality of any deposit of ore or other mineral, which may be deducted, rather than capitalized, only if an election, subjecting the taxpayer to certain recapture provisions, is made under section 617.[7] No such election was made with respect to the expenses in issue here. Moreover, because section 617 is intended to cover services before the development stage has been reached (sec. 1.617–7, Income Tax Regs.), its theory is totally inconsistent with petitioners' claim under section 616. Thus, the only theory under which petitioners would be entitled to deduct their "out-of-pocket" $30,000 paid to Erickson would be the theft-loss theory; but such claim would have to be made in a subsequent year and is not precluded by the agreement for settlement.

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[6] Rule 1(a), Tax Court Rules of Practice and Procedure, provide in part as follows:

"Where in any instance there is no applicable rule of procedure, the Court or the Judge before whom the matter is pending may prescribe the procedure, giving particular weight to the Federal Rules of Civil Procedure to the extent that they are suitably adaptable to govern the matter at hand."

Petitioners have affirmatively asserted that they do not intend to litigate their entitlement to the deductions in issue here. Thus they have, in effect, admitted that they do not intend properly to prosecute the case, at least as to that issue. On the entire record, we conclude that there is no injustice in holding them to the agreement made by Smith as their counsel of record. Their motion will, therefore, be denied.

An appropriate order will be issued.

TEDD N. CROW, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 32439–83. Filed August 26, 1985.

P's motion for summary judgment that capital gain realized after expatriation is exempt from U.S. tax under the 1942 income tax treaty between United States and Canada. *Held,* petitioner is not taxable under sec. 877, I.R.C. 1954, notwithstanding the "saving clause" contained in the treaty. *Held,*

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[7] See also *Baxter v. Commissioner,* T.C. Memo. 1985–415.

further, the treaty does not preclude the United States from taxing imputed interest income under sec. 483, I.R.C. 1954.

Donald F. Wood, for the petitioner.
Sheri A. Wilcox, for the respondent.

OPINION

COHEN, *Judge*: This case is before the Court on petitioner's motion for summary judgment under Rule 121, Tax Court Rules of Practice and Procedure. Respondent determined the following deficiencies in and additions to petitioner's Federal income taxes:

		Additions to tax			
Year	*Deficiency*	*Sec. 6651(a)*[1]	*Sec. 6653(a)(1)*	*Sec. 6653(a)(2)*	*Sec. 6654*
1978	$1,657,734	0	$82,899	0	0
1979	78,790	$19,698	3,940	0	$19,057
1980	156,410	39,103	7,821	0	9,986
1981	123,772	30,943	6,189	(1)	9,561
1982	71,414	17,854	3,571	(1)	6,953

[1] Amount to be computed upon assessment.

The issues for decision are as follows: (1) Whether the March 4, 1942, income tax treaty between the United States and Canada (Convention on Double Taxation, Mar. 4, 1942, United States-Canada, 56 Stat. 1399, T.S. No. 983, hereinafter referred to as the Canadian treaty) precludes the United States from taxing petitioner's capital gain income under section 877; and (2) if so, whether all of the income realized by petitioner in connection with the transactions described below is exempt from U.S. taxation under the Canadian treaty.

Petitioner and respondent have either agreed to as true, or conceded solely for the purpose of our ruling on, petitioner's motion the following facts:

Prior to November 1978, petitioner was a citizen and a resident of the United States. Petitioner moved to Canada on November 20, 1978, and renounced his U.S. citizenship on November 24, 1978. After the latter date, petitioner was a nonresident alien of the United States without a permanent establishment in the United States. The avoidance of United

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

States taxes was a principal purpose of petitioner's expatriation.

When petitioner moved to Canada, he owned all of the outstanding stock of a certain U.S. corporation. On December 1, 1978, petitioner sold his entire stock interest in exchange for a $6,366,000 note payable over a 20-year period and providing for no interest charges as long as payments on the note were timely made.

Petitioner did not report any income on any U.S. tax return with respect to the above transactions. Respondent determined that petitioner was taxable by the United States on long-term capital gain income in 1978 and on imputed interest income (under section 483) in the remaining years in issue.

Issue 1. Capital Gain

Article VIII of the Canadian treaty provides:

> Gains derived in one of the contracting States from the sale or exchange of capital assets by a resident or a corporation or other entity of the other contracting State shall be exempt from taxation in the former State, provided such resident or corporation or other entity has no permanent establishment in the former State.

Petitioner contends that, under article VIII, he is exempt from U.S. tax on the gain realized upon the sale of the stock.

Respondent argues that petitioner is taxable on the gain under section 877, which imposes a special tax on a nonresident alien who relinquished his U.S. citizenship to avoid taxes.[2] According to respondent, the "saving clause" contained in article XVII of the Canadian treaty reserves the right of the United States to tax petitioner under section 877 notwithstanding article VIII. Article XVII provides:

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[2] As in effect in 1982, sec. 877 provides, in relevant part:

SEC. 877. EXPATRIATION TO AVOID TAX.

(a) IN GENERAL.—Every nonresident alien individual who at any time after March 8, 1965, and within the 10-year period immediately preceding the close of the taxable year lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

(b) ALTERNATIVE TAX.—A nonresident alien individual described in subsection (a) shall be taxable for the taxable year as provided in section 1, 55, or 402(e)(1), except that—

(1) the gross income shall include only the gross income described in section 872(a) (as modified by subsection (c) of this section), and

(2) the deductions shall be allowed if and to the extent that they are connected with the gross income included under this section, except that the capital loss carryover provided by section 1212(b) shall not be allowed; and the proper allocation and apportionment of the deductions for this purpose shall be determined as provided under regulations prescribed by the Secretary.

> Notwithstanding any other provision of this Convention, the United States of America in determining the income and excess profit taxes, including all surtaxes, of its citizens or residents or corporations, may include in the basis upon which such taxes are imposed all items of income (other than income within the scope of paragraph 1 (b) of Article VI) taxable under the revenue laws of the United States of America as though this convention had not come into effect.[3]

Respondent does not argue that petitioner was a citizen or a resident of the United States when he realized the income in issue. Instead, respondent's position is that taken in Rev. Rul. 79–152, 1979–1 C.B. 237, which presented a situation almost identical to the present case:

> Although the treaty contains a * * * [provision] regarding United States taxation of capital gains, such provision is subject to the treaty "saving clause" reserving the right of the United States to tax its citizens as though the treaty had not come into effect. This aspect of the saving clause is intended to preserve, with certain specific exceptions, United States taxation on the basis of citizenship, notwithstanding the limitations on United States taxation otherwise imposed by the treaty. Taxation under section 877 is a manifestation of United States taxation on the basis of citizenship; in effect, the section imposes income tax liability, by reason of citizenship, for ten years following a tax motivated expatriation. Consequently, the income tax treaty does not exempt from United States taxation taxpayer's capital gain * * * because by virtue of section 877 the taxpayer remains subject to tax as a United States citizen within the meaning of the treaty "saving clause." [Rev. Rul. 79–152, *supra*, 1979–1 C.B. at 237–238.]

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(c) SPECIAL RULES OF SOURCE.—For purposes of subsection (b), the following items of gross income shall be treated as income from sources within the United States:

* * * * * * *

(2) STOCK OR DEBT OBLIGATIONS.—Gains on the sale or exchange of stock issued by a domestic corporation * * *

Minor amendments, not relevant herein, were made to sec. 877 during the years in issue. See Technical Corrections Act of 1979, Pub. L. 96–222, sec. 104(a)(1), (4)(H)(v), 94 Stat. 194, 214, 217; Revenue Act of 1978, Pub. L. 95–600, sec. 431(e)(5), 92 Stat. 2763, 2876.

[3] A supplementary convention signed in 1950 added the parenthetical language to art. XVII. See Supplementary Convention on Double Taxation, June 12, 1950, United States-Canada, art. I(m), 2 U.S.T. 2235, T.I.A.S. No. 2347. This language is not relevant herein.

Respondent thus interprets the term "citizens" in article XVII of the Canadian treaty to include former citizens who expatriated to avoid tax.

The goal of treaty interpretation is "to give the specific words * * * a meaning consistent with the genuine shared expectations of the contracting parties." *Maximov v. United States*, 299 F.2d 565, 568 (2d Cir. 1962), affd. 373 U.S. 49 (1963). We must examine not only the literal language of article XVII but also its purpose, history, and context. See *Kolovrat v. Oregon*, 366 U.S. 187 (1961); *Cook v. United States*, 288 U.S. 102 (1933); *Sullivan v. Kidd*, 254 U.S. 433 (1921).

Our examination reveals that the contracting parties had no intention to define the term "citizens" in article XVII more broadly than its literal meaning. As stated in Rev. Rul. 79-152, respondent justifies a nonliteral definition of "citizens" as reflecting the reservation in the saving clause of the right of the United States to tax on the basis of citizenship. Article XVII of the Canadian treaty, however, was intended only to preserve U.S. taxation *of citizens* on the basis of citizenship.

The United States was historically, and continues to be, virtually unique in taxing its citizens, wherever resident, on their worldwide income, solely by reason of their citizenship. See *Filler v. Commissioner*, 74 T.C. 406, 410 (1980), 3 R. Rhodes & M. Langer, Income Taxation of Foreign Related Transactions, sec. 9.06[1][b] (1984); Hitch, "Tax-Motivated Expatriation," 39 N.Y.U. Inst. Fed. Taxation 34-1, 34-3 (1981). The United States, therefore, traditionally insisted upon maintaining the ability to tax its citizens resident in the treaty partner, as manifested by the saving clause contained in the first income tax treaty with Canada: "The provisions of this Convention shall not apply to citizens of the United States of America domiciled or resident in Canada." Convention on Income Taxation, Dec. 30, 1936, United States-Canada, art. II, 50 Stat. 1399, T.S. No. 920 (terminated Apr. 30, 1941). See generally *Filler v. Commissioner*, 74 T.C. at 410; *Crerar v. Commissioner*, 26 T.C. 702, 705-706 (1956); Department of Treasury, Technical Explanation of the United States and United Kingdom Income Tax Treaty 2 (published as Treasury Department Press Release B-90 on Mar. 9, 1977) ("The saving clause is of principal importance to the United States because the United States taxes its citizens, residents, and corporations on a worldwide basis, regardless of where they reside or derive income."); Bischel, "Basic Income Tax Treaty Structures," Income Tax Treaties 1, 11 (1978).

Interpretative documents published contemporaneously with the 1942 Canadian treaty indicate that the purpose of article XVII was to continue this reservation by the United States. "Article XVII makes clear that the convention leaves undisturbed the taxation by the United States of its own citizens and corporations." Letter from Acting Secretary of State Welles to President Roosevelt (Mar. 6, 1942).

> The convention makes no change in the United States tax liability of American citizens and residents and domestic corporations. Under the Federal income-tax laws, such taxpayers are taxable upon their income from all sources whether derived from within or without the United States. * * * [S. Exec. Rept. 3, 77th Cong., 2d Sess. 1 (1942).]

"The convention does not, except as provided in the first paragraph of article VI, affect the liability * * * of a citizen of the United States residing in Canada." Reg. sec. 7.21, 1943 C.B. 534.[4] As the Supreme Court stated in *Kolovrat v. Oregon*, 366 U.S. 187, 194 (1961), "While courts interpret treaties for themselves, the meaning given them by the departments of government particularly charged with their negotiation and enforcement is given great weight."

We have found no indication whatsoever that the contracting parties intended, or even contemplated, the application of article XVII to nonresident aliens of the United States. Indeed, the contemporaneous regulations issued by the Treasury Department implicitly rejected such an application of the saving clause. In describing the second paragraph of article XV, in which the United States agreed to allow a credit against U.S. income and excess profits taxes for such taxes paid to Canada,[5] the regulations provided:

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[4] Reg. sec. 7.21 is now codified at 26 C.F.R. sec. 519.102(c) (1980). See 25 Fed. Reg. 14,021, 14,022 (1960).

The regulations were issued pursuant to art. XVIII of the Canadian treaty (see 1943 C.B. 533), which provides in part:

"The competent authorities of the two contracting States may prescribe regulations to carry into effect the present Convention within the respective States and rules with respect to the exchange of information."

[5] Art. XV provides in full:

1. As far as may be in accordance with the provisions of The Income Tax Act, Canada agrees to allow as a deduction from the Dominion income and excess profits taxes on any income which was

> Credit Against United States Tax Liability for Income Tax Paid to Canada.—For the purpose of avoidance of double taxation, Article XV provides that, on the part of the United States, there shall be allowed against the United States income and excess profits tax liability a credit for any such taxes paid to Canada by United States citizens or domestic corporations. Such principle also applies in the case of a citizen of Canada residing in the United States. Such credit, however, is subject to the limitations provided in section 131, Internal Revenue Code (relating to the credit for foreign taxes). See sections 19.131-1 to 19.131-8, Regulations 103. *The article is complementary to the provisions of Article XVII,* which provides that the United States in ascertaining the income and excess profits tax of its citizens and residents and corporations may take into the basis upon which such taxes are imposed all items of income as though the convention had not come into effect. [Reg. sec. 7.35, 1943 C.B. 541. Emphasis supplied.][6]

Section 131 of the 1939 Code, effective when the above regulation was issued, provided no credit for nonresident aliens.

Respondent argues that Canada has no reason to object to his interpretation of the saving clause because "It is implausible to believe another nation has any significant interest in negotiating benefits for United States citizens who might one day expatriate with a principal purpose of avoiding United States taxes and reside in their country." In the first paragraph of article XV, however, Canada agreed to allow its taxpayers a credit to reflect taxes paid to the United States on U.S. source income. Because an American expatriate in Canada might be entitled to a higher Canadian tax credit

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derived from sources within the United States of America and was there taxed, the appropriate amount of such taxes paid to the United States of America.

2. As far as may be in accordance with the provisions of the United States Internal Revenue Code, the United States of America agrees to allow as a deduction from the income and excess profits taxes imposed by the United States of America the appropriate amount of such taxes paid to Canada.

Prior to the supplementary convention signed in 1950, art. XV provided as follows:

> In accordance with the provisions of Section 8 of the Income War Tax Act as in effect on the day of the entry into force of this Convention, Canada agrees to allow as a deduction from the Dominion income and excess profits taxes on any income which was derived from sources within the United States of America and was there taxed, the appropriate amount of such taxes paid to the United States of America.
>
> In accordance with the provisions of Section 131 of the United States Internal Revenue Code as in effect on the day of the entry into force of this Convention, the United States of America agrees to allow as a deduction from the income and excess profits taxes imposed by the United States of America the appropriate amount of such taxes paid to Canada.

See Supplementary Convention on Double Taxation, June 12, 1950, United States-Canada, art. I(*1*), 2 U.S.T. 2235, T.I.A.S. No. 2347.

[6] Reg. sec. 7.35 is now codified at 26 C.F.R. sec. 519.116 (1980). See 25 Fed. Reg. 14,021, 14,022 (1960).

where section 877 applies,[7] Canada indeed possesses a fiscal interest in the applicability of the provision. Moreover, even if Canada has no interest in encouraging expatriation from the United States, Canada could reasonably object to the scope of section 877, which would deny treaty benefits for 10 years to expatriate Americans who acquired Canadian citizenship and residency. Finally, under respondent's interpretation of the term "citizens," the United States could, *without violating the Canadian treaty*, enact legislation significantly more burdensome to Canadian interests than is section 877.

In light of the purpose behind the saving clause, the absence of any indication that Canada anticipated respondent's interpretation with respect to the 1942 treaty, and the potential objections of Canada thereto, we find no support for respondent's expansive reading of article XVII.

> it is particularly inappropriate for a court to sanction a deviation from the clear import of a solemn treaty between this Nation and a foreign sovereign, when, as here, there is no indication that application of the words of the treaty according to their obvious meaning effects a result inconsistent with the intent or expectations of its signatories. * * * [*Maximov v. United States*, 373 U.S. 49, 54 (1963).]

See also *Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176 (1982); *Rust v. Commissioner*, 85 T.C. 284 (1985).

The Canadian treaty, like an act of Congress, is part of "the supreme Law of the Land." U.S. Const. art. VI, cl. 2. See *Reid v. Covert*, 354 U.S. 1, 18 (1957) (Opinion of Justice Black) and cases cited therein. Although Congress can override a treaty provision by enacting a subsequent statute (see *Reid v. Covert*, *supra*, and cases cited therein), respondent does not argue that Congress intended to overrule or supersede any provision of the Canadian treaty in enacting section 877 pursuant to the Foreign Investors Tax Act of 1966, Pub. L. 89–809, sec. 103(f), 80 Stat. 1539, 1551–1552 (hereinafter referred to as FITA). Such an argument would indeed be unpersuasive in light of section 110 of FITA, which provides:

> SEC. 110. TREATY OBLIGATIONS.
>
> No amendment made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States.

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[7] Whether and the extent to which an increased United States tax liability resulting from the application of section 877 would increase the Canadian tax credit depend upon the amount of the expatriate's Canadian tax subject to the credit.

For purposes of the preceding sentence, the extension of a benefit provided by any amendment made by this title shall not be deemed to be contrary to a treaty obligation of the United States. [FITA, *supra*, 80 Stat. 1575.]

See also secs. 894(a) and 7852(d).

Respondent, instead, argues that we should construe the Canadian treaty and section 877 so as to give effect to both pronouncements. According to respondent, the purpose of section 877 is to prevent tax-motivated expatriation, and only his construction of the saving clause will effect this goal. We agree with respondent that we "must read the * * * [treaty and the statute] to give effect to each if we can do so while preserving their sense and purpose." *Watt v. Alaska*, 451 U.S. 259, 267 (1981). See also *United States v. Lee Yen Tai*, 185 U.S. 213, 221–222 (1902). Implicit in the above rule, however, is that "A canon of construction is not a license to disregard clear expressions of * * * congressional intent." *Andrus v. Glover Construction Co.*, 446 U.S. 608, 619 (1980) (quoting DeCoteau v. District County Court, 420 U.S. 425, 447 (1975)).

We note initially that respondent's interpretation is inconsistent with the literal language of section 877, which imposes a tax on a "nonresident alien individual." Sec. 877(a) and (b). Such a taxpayer could not be a citizen of the United States. Sec. 1.871–2(a), Income Tax Regs.

The history and purpose of FITA, in general, and section 877, in particular, confirm that Congress rejected the interpretation urged upon us by respondent. On October 2, 1963, President Kennedy appointed a task force, chaired by Treasury Secretary Fowler, to propose methods of promoting increased foreign investment in securities of U.S. companies and increased foreign financing for U.S. businesses operating abroad. Report to the President of the United States from the Task Force on Promoting Increased Foreign Investment and Increased Foreign Financing iii, v (Apr. 27, 1964). The task force concluded that many of the then-existing tax rules applicable to foreign investors in the United States were outmoded and deterred foreign investment in the United States. Based upon the conclusions of the task force, the Treasury Department submitted proposed legislation to Congress on March 8, 1965. Hearings on H.R. 5916 Before the House Comm. on Ways and Means, 89th Cong., 1st Sess. 25 (1965) (Statement of Secretary Fowler) (hereinafter cited as

House Hearings). On that date, Chairman Mills of the Ways and Means Committee introduced H.R. 5916, a bill designed to carry out the recommendations of the Treasury Department. 111 Cong. Rec. 4393 (1965); H. Rept. 1450, 89th Cong., 2d Sess. (1966), 1966–2 C.B. 967, 970.

Whereas the primary objective of the initial Treasury Department proposal was to stimulate foreign investment in the United States, the Ways and Means Committee broadened the scope of the bill to include equalizing the tax treatment accorded such investment. H. Rept. 1450, *supra*, 1966–2 C.B. at 970. Chairman Mills thus introduced a revised version of the bill as H.R. 11297 on September 28, 1965, and a further revision as H.R. 13103 on February 28, 1966. 111 Cong. Rec. 25,411 (1965); 112 Cong. Rec. 4229 (1966). The Senate ultimately adopted H.R. 13103 after minor amendments (see S. Rept. 1707, 89th Cong., 2d Sess. (1966), 1966–2 C.B. 1059, 1064), and the bill was signed into law (as FITA) by the President on November 13, 1966.[8]

The provisions in FITA for the taxation under the Internal Revenue Code of nonresident alien individuals were substantially the same as those provisions in H.R. 5916. Compare FITA, sec. 103, 80 Stat. 1547–1555 with H.R. 5916, 89th Cong., 1st Sess., sec. 3 (1965). Prior to the enactment of FITA, the Code prescribed complex rules for the taxation of U.S. source investment income realized by nonresident aliens. Nonresident aliens engaged in a trade or business in the United States were taxed on all U.S. source income at regular, graduated rates. A nonresident alien individual not engaged in a trade or business in the United States generally was taxed on certain U.S. source investment income at a flat 30-percent rate, if the individual realized not greater than $21,200 of such income. If such alien realized more than $21,200 of such income, however, he was taxed at regular graduated rates or at the 30-percent rate, whichever resulted in greater tax liability. Both Congress and the Treasury believed that the above system was arbitrary and unnecessarily complicated and that uniform taxation at the 30-percent rate of nonbusiness income realized by nonresident aliens would encourage foreign investment in the United States. The solution initially proposed by the Treasury and ultimately adopted by Congress generally was to tax at regular graduated rates only the income of nonresident aliens that is attributable to a trade or business in the United States. Most U.S. source investment income not so attributable would be subject to the 30-percent tax, regardless of the amount of such income and regardless of whether the individual maintained a trade or business in the United States. H. Rept. 1450, *supra*, 1966-2 C.B. at 978–980; S. Rept. 1707, *supra*, 1966-2 C.B. at 1074–1076; Department of Treasury, Explanation of H.R. 5916, reprinted in House Hearings, *supra* at 16–17. FITA thus codified in section 871 the now-familiar concept of income "effectively connected" with the conduct of a U.S. trade or business. FITA, sec. 103(a), 80 Stat. 1457–1458.

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[8] The Senate added tits. II through IV to Pub. L. 89–809, secs. 201–402, 80 Stat. 1575–1590 (1966), prescribing miscellaneous provisions unrelated to FITA.

Congress and the Treasury shared the concern, however, that the elimination of progressive taxation with respect to nonbusiness income realized by nonresident aliens might encourage some individuals to renounce their U.S. citizenship and move abroad. See H. Rept. 1450, *supra*, 1966-2 C.B. at 982–983; S. Rept. 1707, *supra*, 1966-2 C.B. at 1078–1079; Department of Treasury, Explanation of H.R. 5916, *reprinted in* House Hearings, *supra* at 20–21. See also *Kronenberg v. Commissioner*, 64 T.C. 428 (1975). To prevent this potential abuse, Congress codified section 877, the provision here in issue, under sec. 103(f) of FITA.[9] Section 877 is virtually identical, in both operative scope and language, to the Treasury Department's initial proposal embodied in section 3(d) of H.R. 5916. Indeed, the Senate restored the 10-year period of applicability for section 877, after the House had shortened the period proposed by the Treasury Department to 5 years. See 112 Cong. Rec. 26,386 (1966); Hearings on H.R. 13130 Before the Senate Comm. on Finance, 89th Cong., 2d Sess. 54 (1966). Compare FITA, sec. 103(f), 80 Stat. 1551 and H.R. 5916, 89th Cong., 1st Sess., sec. 3(d) (1965), with H.R. 13103, 89th Cong., 2d Sess. sec. 3(e) (1966).

Respondent is thus generally correct in asserting that the purpose behind section 877 is to prevent tax-motivated expatriation. As respondent notes, the Treasury Department expressed this purpose in its explanation of H.R. 5916, which Chairman Mills introduced into the Congressional Record:

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[9] FITA also added analogous provisions in the estate and gift tax areas, codified at secs. 2107 and 2501(a), respectively. See FITA, secs. 108(f), 109(a), 80 Stat. 1573–1575.

> As a result of the proposed elimination of graduated rates, * * * an American citizen who gives up his citizenship and moves to a foreign country would be able to very substantially reduce his U.S. * * * income tax liabilit[y].
>
> While it may be doubted that there are many U.S. citizens who would be willing to give up their U.S. citizenship no matter how substantial the tax incentive, a tax incentive so great might lead some Americans to surrender their citizenship for the ultimate benefit of their families. Thus, it seems desirable, if progressive rates are eliminated for nonresident aliens, * * * that steps be taken to limit the tax advantages of alienage for our citizens.
>
> The recommended legislation accomplishes this by providing that a nonresident alien who surrendered his U.S. citizenship within the preceding 10 years shall remain subject to tax at regular U.S. rates on all income derived from U.S. sources. * * *
>
> [111 Cong. Rec. 4372 (1965).]

In relying upon the above language, however, respondent neglects an important qualification placed upon the general purpose of section 877. As the Treasury explanation continued only two paragraphs later, "Th[is] provision * * * would not apply if contravened by the provisions of a tax convention with a foreign country." The explanation merely made explicit the implicit—that under section 110 of FITA, section 877, like all FITA provisions, does not apply where its application would be inconsistent with a treaty.

Moreover, as the Ways and Means Committee report on H.R. 13103 makes clear, section 110 of FITA applies to treaties in force on the date of enactment:

> Section 10 of the bill [section 110 of FITA] provides that, if the application of any provision of the bill would be contrary to a treaty obligation of the United States *in force on the date of enactment of the bill,* the treaty obligation is to prevail. [H. Rept. 1450, *supra*, 1966–2 C.B. at 1052. Emphasis supplied.]

Among all the income tax treaties in force on the date of enactment of FITA that we have reviewed, we have not found a single treaty in which the conflict with section 877 was more direct than the conflict between section 877 and article VIII of the Canadian treaty.[10] Each of the other treaties either contained a saving clause similar to article XVII or, less frequently, defined resident of the treaty partner so as to preserve the right of the United States to tax its citizens. None of the treaties contained specific language precluding the application of section 877 or a like statute. Thus section 110 would have no purpose with respect to section 877 if it did not prevent the application of section 877 in the present case.[11]

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[10] See Convention on Double Taxation, Oct. 25, 1956, United States-Austria, 8 U.S.T. 1699, T.I.A.S. No. 3923; Convention on Double Taxation, Oct. 28, 1948, United States-Belgium, 4 U.S.T.

Respondent argues that section 110 of FITA is only precautionary and was not intended as a response to an identified conflict between section 877 and any treaty. Respondent's argument necessarily implies, however, that Congress intended section 877 to apply in the face of *all* treaties in force as of the enactment of FITA. In light of the general applicability of section 110 and the contemporaneous Treasury explanation, had Congress intended such, it would have so indicated. Any doubt that we should reject respondent's implausible assertion of congressional intent is resolved by the following statement of Assistant Treasury Secretary Surrey:

1647, T.I.A.S. No. 2833; Convention on Double Taxation, May 6, 1948, United States-Denmark, 62 Stat. 1730, T.I.A.S. No. 1854; Convention on Double Taxation, Mar. 3, 1952, United States-Finland, 3 U.S.T. 4485, T.I.A.S. No. 2596; Convention on Double Taxation, Oct. 18, 1946, United States-France, 64 Stat. (3) B3, T.I.A.S. No. 1982; Convention on Double Taxation, July 22, 1954, United States-Germany, 5 U.S.T. 2768, T.I.A.S. No. 3133; Convention on Double Taxation, Feb. 20, 1950, United States-Greece, 5 U.S.T. 47, T.I.A.S. No. 2902; Convention on Double Taxation, Sept. 13, 1949, United States-Ireland, 2 U.S.T. 2303, T.I.A.S. No. 2356; Convention on Double Taxation, Mar. 30, 1955, United States-Italy, 7 U.S.T. 2999, T.I.A.S. No. 3679; Convention on Double Taxation, Apr. 16, 1954, United States-Japan, 6 U.S.T. 149, T.I.A.S. No. 3176; Convention on Income and Property Taxes, Dec. 18, 1962, United States-Luxembourg, 15 U.S.T. 2355, T.I.A.S. No. 5726; Convention on Double Taxation, Apr. 29, 1948, United States-the Netherlands, 62 Stat. 1757, T.I.A.S. No. 1855; Convention on Double Taxation, June 13, 1949, United States-Norway, 2 U.S.T. 2323, T.I.A.S. No. 2357; Convention on Double Taxation, July 1, 1957, United States-Pakistan, 10 U.S.T. 984, T.I.A.S. No. 4232; Convention on Double Taxation, Nov. 14, 1939, United States-Sweden, 54 Stat. 1759, T.S. No. 958; Convention on Double Taxation, May 24, 1951, United States-Switzerland, 2 U.S.T. 1751, T.I.A.S. No. 2316; Convention on Double Taxation, Dec. 13, 1946, United States-South Africa, 3 U.S.T. 3821, T.I.A.S. No. 2510; Convention on Double Taxation, Apr. 16, 1945, United States-United Kingdom, 60 Stat. 1377, T.I.A.S. No. 1546.

[11] This conclusion is consistent with the uniform opinion of the commentators who have addressed the issue. See 1 R. Rhoades & M. Langer, Income Taxation of Foreign Related Transactions sec. 2.24[1] (1984); Hitch, "Tax-Motivated Expatriation," 39 N.Y.U. Inst. Fed. Taxation 34-1, 34-28—34-30 (1981); Roberts, "Is Revenue Ruling 79-152, which taxes an expatriate's gain, consistent with the Code?" 51 J. Taxation 204 (1979). See also Bissell, "The Treasury's Model Income Tax Treaty: An Analysis and Appraisal," 3 Int. Tax J. 8, 9 (1976); Langer, "The Need for Reform in the Treaty Area," in Income Tax Treaties 717, 746-748 (Bischel ed. 1978); Ness, "Federal Tax Treatment of Expatriates Entitled to Treaty Protection," 21 Tax Law. 393, 398-399 (1968); Ross, "United States Taxation of Aliens and Foreign Corporations: The Foreign Investors Tax Act of 1966 and Related Developments," 22 Tax L. Rev. 277, 347 (1967); Comment, "Internal Revenue Code Section 877: Expanded Purview Generates Discord in Taxation of the Tax-Motivated Expatriate," 13 Cal. West. Int. L. J. 58 (1983).

> The abandonment of the application of the progressive income tax rates to foreign individuals investing in the United States, the cut-back of other income tax provisions, and the reduction of estate tax rates would establish a distinctly brighter tax picture in the United States for the foreigner. Indeed, the picture is such that Americans may be tempted to become "foreigners" for tax reasons. * * * But to the extent possible we should not permit our tax problems with Americans to act as a bar to rational revisions in our treatment of foreigners. The proposed bill [H.R. 11297] meets this objective by keeping American expatriates still subject to full United States tax on their United States income and assets, for five years after loss of citizenship in the case of the income tax and for ten years in the case of the estate tax, where the loss of citizenship is motivated by the desire to avoid our taxes. *Where such a result is contrary, however, to a tax treaty, the treaty would govern. But since our tax treaties are largely with countries whose tax systems involve rates at significant levels, an expatriate who establishes residence in those countries is not likely to be motivated by a desire to avoid United States taxes.* [Remarks by Stanley S. Surrey, Assistant Secretary of the Treasury, at the Tax Institute of America Symposium (Dec. 2, 1965) 46–47 (published as Treasury Department Press Release F-291, on Dec. 3, 1965). Emphasis supplied.]

Respondent urges us to give deference to "the view of the Treasury Department" expressed in Rev. Rul. 79-152. A revenue ruling represents the view of the Commissioner, not the Treasury Department (*Browne v. Commissioner*, 73 T.C. 723, 731 (1980) (Hall, J., concurring)), and thus is generally only "the contention of one of the parties to the litigation." *Estate of Smead v. Commissioner*, 78 T.C. 43, 47 n. 5 (1982). See *Stubbs, Overbeck & Associates, Inc. v. United States*, 445 F.2d 1142, 1146–1147 (5th Cir. 1971); *Estate of Lang v. Commissioner*, 64 T.C. 404, 406–407 (1975), affd. on this issue 613 F.2d 770, 776 (9th Cir. 1980). Because Rev. Rul. 79-152 does not constitute a consistent and long-standing administrative position with prior congressional or judicial approval, it is not entitled to any special deference in this Court. Cf. *United States v. Correll*, 389 U.S. 299 (1967); *Commissioner v. Stidger*, 386 U.S. 287 (1967).

Even if we attributed greater authority to Rev. Rul. 79-152 than that normally due a revenue ruling, the present case would be governed by the holdings of the Supreme Court in *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982), and *Watt v. Alaska*, 451 U.S. 259 (1981). In both cases, the Supreme Court construed a statute that, like FITA, had been initially proposed and contemporaneously interpreted or applied by an agency that later reversed its position. The Supreme Court in both cases adopted the contemporaneous interpretation or application. In *Vogel Fertilizer Co.*, the Court stated:

> The Treasury Department's explanations of the proposed statute are not, as the dissent in the Court of Claims suggested, a mere "admission against interest" by the Commissioner. 225 Ct. Cl. at 44, 634 F.2d at 514. The expanded definition of "brother-sister controlled group" was proposed by the Treasury Department and adopted in the same form in which it was presented. Of course, it is Congress' understanding of what it was enacting that ultimately controls. But we necessarily attach "great weight" to agency representations to Congress when the administrators "participated in drafting and directly made known their views to Congress in committee hearings." *Zuber v. Allen*, 396 U.S. 168, 192 (1969). * * * [455 U.S. at 31.]

Similarly, in *Watt* the Court concluded:

> the Department of the Interior interpreted the amendments when passed, and for 10 years thereafter, as not altering the distribution formula. The Department's contemporaneous construction carries persuasive weight. *Udall v. Tallman*, 380 U.S. at 16. Such attention to contemporaneous construction is particularly appropriate in these cases, because the Department first proposed the amendment. See *SEC v. Sloan*, 436 U.S. 103, 120 (1978). The Department's current interpretation, being in conflict with its initial position, is entitled to considerably less deference. See *General Electric Co. v. Gilbert*, 429 U.S. 125, 143 (1976). In these cases, we find it wholly unpersuasive. [451 U.S. at 272–273.]

Both petitioner and respondent attempt to support their respective positions based upon the current treaty policy of the United States to insist upon a saving clause specifically reserving its right to tax under section 877. This policy is exemplified by article 1(3) of the U.S. Model Income Tax Treaty[12] and the saving clauses contained in many recently negotiated treaties, including the treaty currently in effect with Canada.[13] Petitioner argues that the mere use of the

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[12] (3) Notwithstanding any provision of this Convention except paragraph (4) of this Article, a Contracting State may tax its residents (as determined under Article 4 (Fiscal Domicile)), and by reason of citizenship may tax its citizens, as if this Convention had not come into effect. For this purpose the term "citizen" shall include a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of income tax, but only for a period of 10 years following such loss.

[13] The Convention on Taxes on Income and Capital, Sept. 26, 1980, United States-Canada, ____ U.S.T. ____, T.I.A.S. No. ____ (1 CCH Tax Treaties par. 1301), became effective and superseded the 1942 Canadian treaty on Aug. 16, 1984. Art. XXIX(2) of the new treaty provides:

> 2. Except as provided in paragraph 3, nothing in the Convention shall be construed as preventing a Contracting State from taxing its residents (as determined under Article IV (Residence)) and, in the case of the United States, its citizens (including a former citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax, but only for a period of

more specific language implies that section 877 does not apply through a "general" saving clause like article XVII of the Canadian treaty. Respondent contends that the more specific saving clauses represent language clarifications and not substantive changes in the ability of the United States to tax expatriates.

After examining many recent treaties, we conclude that the current treaty practice of the United States sheds little light on the issue before us. The reports of the Senate Foreign Relations Committee and the Joint Committee on Taxation with respect to the new Canadian treaty are typical of the contemporaneous interpretations of "specific" saving clauses:

> Under Section 877, a former citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. income tax, will, in certain cases, be subject to tax for a period of 10 years following the loss of citizenship. The proposed treaty contains the standard provision found in the U.S. model and most recent treaties specifically retaining the right to tax a former U.S. citizen whose loss of citizenship had as one of its principal purposes the avoidance of U.S. tax. This right to tax continues whether the former citizen had a principal purpose of avoiding income tax or some other tax. *Even absent a specific provision the IRS takes the position that the U.S. retains the right to tax former citizens resident in the treaty partner.* [S. Exec. Rept. 22, 98th Cong., 2d Sess. 47 (1984). Emphasis supplied.]

Accord, Staff of Joint Comm. on Taxation, Explanation of Proposed Income Tax Treaty (and Proposed Protocols) Between the United States and Canada 54 (Comm. Print 1984). The interpretations thus carefully identify respondent's position as his own and exhibit no intention to adopt such position.

Petitioner cites recent treaties containing traditional (i.e., "general") saving clauses in support of his position that the two types must possess different meanings. We note, however, that the treaty with Malta contains a general saving clause (Agreement on Income Taxes, Mar. 21, 1980, United States-Malta, art. 1(3), ____ U.S.T. ____, T.I.A.S. No. 10567 (1984-2 C.B. 339)), but the Senate Foreign Relations Committee and the Joint Committee on Taxation interpreted that clause in accordance with respondent's position:

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ten years following such loss) and companies electing to be treated as domestic corporations, as if there were no convention between the United States and Canada with respect to taxes on income and on capital.

> The treaty does not contain the standard provision found in the U.S. model, and most recent treaties, specifically retaining the right to tax former citizens. However, the article is intended to cover former citizens to reserve the right of the U.S. to tax former citizens under section 877. This is the position of the Internal Revenue Service. See Rev. Rul. 79–152, 1979–1 C.B. 237. [S. Exec. Rept. No. 30, 97th Cong., 1st Sess. 6 (1981), 1984–2 C.B. 353; Staff of Joint Comm. on Taxation, Explanation of Proposed Income Tax Treaty Between the United States and the Republic of Malta 9 (Comm. Print 1981).][14]

While these interpretations might initially appear to undermine petitioner's position herein, the Maltese treaty was signed after the promulgation of Rev. Rul. 79–152. During the negotiation of the treaty, Malta could have explicitly or implicitly consented to the application of section 877 despite the lack of a specific reservation in the saving clause.[15] Indeed, the explanations accompanying the treaty with Egypt (signed 5 months after the Maltese treaty, containing the traditional saving clause, and considered contemporaneously with the Maltese treaty by the Senate Foreign Relations Committee) do not indicate that the United States may apply section 877 through the saving clause. See S. Exec. Rept. 27, 97th Cong., 1st Sess. 12 (1981); Staff of Joint Comm. on Taxation, Explanation of Proposed Income Tax Treaty Between the United States and Egypt 14 (Comm. Print 1981). In any event, treaties coming into force after the enactment of FITA may have little relevance to the issue before us, as section 110 of FITA may not apply to such treaties. See H. Rept. 1450, *supra*, 1966–2 C.B. at 1052.

We thus conclude that the 1942 Canadian treaty, as agreed to by the contracting parties, does not allow the United States to tax former citizens under section 877. Although Congress could have provided otherwise by statute, Congress did not do so with the enactment of FITA. Respondent argues at length what Congress *could* have done instead of enacting section 877. He asserts, for example, that Congress could have prescribed a 10-year waiting period before loss of citizenship would be effective or placed conditions upon expatriation. The issue before us, however, is not what Congress could have done but what it did. See *Dillin v. Commissioner*, 56 T.C. 228, 240–241 (1971).

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[14] The Treasury Department's explanation of the Maltese treaty would not suggest such a result:

"Paragraph (3) contains the traditional 'saving clause' under which each Contracting State reserves the right to tax its residents, as determined under Article 4 (Fiscal Residence), and its citizens as if the Treaty had not come into effect. [Department of Treasury, Technical Explanation of the Agreement Between the United States of America and the Republic of Malta with Respect to Taxes on Income 2 (Published in Treasury Department Press Release R–367 on Sept. 24, 1981), 1984–2 C.B. 366.]"

This interpretation is consistent with the typical interpretations accompanying recent treaties containing general savings clauses.

[15] Cf. Rosenbloom, "Current Developments in Regard to Tax Treaties," 40 N.Y.U. Inst. Fed. Taxation 31–1, 31–93 n. 247 (1982) (similar conclusion with respect to Jamaican treaty prior to protocol amendment).

While the result reached in this case may seem undesirable on the assumed facts, we cannot let our policy preferences control our decision. Congress must weigh the potential for abuse against sound foreign policy considerations. Neither respondent through administrative action nor the Court through judicial interpretation can substitute its judgment for that of Congress in these matters.

Issue 2. Imputed Interest

Petitioner argues that the entire difference between the face amount of the non-interest-bearing note and his basis in the stock exchanged therefor is exempt from U.S. taxation under article VIII of the Canadian treaty. Respondent contends that, even if section 877 is inapplicable to petitioner, petitioner is taxable on imputed interest income under section 483, although at the 15-percent rate prescribed in article XI(1).[16]

Where the Internal Revenue Code provides for the taxation of income, "Whatever basis there may be * * * for relieving the * * * tax must be found in the words or implications of the Convention." *Maximov v. United States*, 373 U.S. 49, 51 (1963). Cf. *Johansson v. United States*, 336 F.2d 809, 811 (5th Cir. 1964); *Di Portanova v. United States*, 690 F.2d 169, 177 (Ct. Cl. 1982); *Great-West Life Assur. Co. v. United States*, 678 F.2d 180, 181–182 (Ct. Cl. 1982); *Kimball v. Commissioner*, 6 T.C. 535 (1946).

Article XI(1) of the Canadian treaty provides:

> 1. The rate of income tax imposed by one of the contracting States, in respect of income (other than earned income) derived from sources therein, upon individuals residing in, or corporations organized under the laws of, the

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[16] The parties apparently agree that the income in issue is from sources within the United States and would thus be taxable under sec. 871(a), absent the Canadian treaty.

> other contracting State, and not having a permanent establishment in the former State, shall not exceed fifteen percent for each taxable year.

Petitioner first correctly notes that income subject to article XI(1) includes interest. He then argues that the term "interest," as defined by paragraph 6(b) of the protocol executed contemporaneously with the Canadian treaty, expressly excludes imputed interest. Therefore, he asserts, the amount that respondent treats as imputed interest must be part of his gain exempted from tax under article VIII.

Paragraph 6(b) of the protocol provides:

> (b) the term "interest," as used in this Convention, *shall include* income arising from interest-bearing securities, public obligations, mortgages, hypothecs, corporate bonds, loans, deposits and current accounts. [Emphasis supplied.][17]

The protocol thus does not set forth an exclusive definition of "interest," nor does it expressly exclude imputed interest from the term.

More fundamentally, article XI(1) applies not only to interest but also to other types of unearned income. The regulations confirm this plain reading of article XI(1):

> Under the terms of the convention, * * * the rate of tax * * * is reduced to 15 percent in the case of * * * [certain] individuals who are residents of Canada and in the case of * * * [certain] corporations organized under the laws of Canada, with respect to amounts received from sources within the United States as interest (except interest exempt from tax), dividends, rents, salaries, wages, premiums, compensations, remunerations, emoluments *or other fixed or determinable annual or periodical gains, profits and income*, other than annuities and pensions which are exempt from the tax under the convention. * * * [26 C.F.R. sec. 519.112 (1980). Emphasis supplied.][18]

Thus, even if paragraph 6(b) of the protocol excluded imputed interest from "interest," article XI(1) would nevertheless apply to imputed interest, like most other forms of unearned income.[19]

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[17] Par. 6 of the protocol was initially numbered par. 7. See Supplementary Convention on Double Taxation, Aug. 8, 1956, United States-Canada, art. I(d), 8 U.S.T. 1619, T.I.A.S. No. 3916.

[18] Reg. sec. 519.112 was initially numbered sec. 7.31 (see 25 Fed. Reg. 14,021, 14,022 (1960)) and does not reflect the addition of the phrase "(other than earned income)" to art. XI(1) by the supplementary convention signed in 1956. See Supplementary Convention on Double Taxation, Aug. 8, 1956, United States-Canada, art. I(c), 8 U.S.T. 1619, T.I.A.S. No. 3916.

[19] The definition provided in par. 6(b) of the protocol is relevant for treaty provisions that refer specifically to "interest," such as art. XII.

Article VIII provides a specific exception from article XI(1) with respect to one type of unearned income—gain from the sale or exchange of capital assets. Yet, even if we assumed that imputed interest income is somehow outside the scope of article XI(1), we find no indication, in the text of the treaty or otherwise, that article VIII would apply to such income. Petitioner apparently belives that the inapplicability of article XI(1) automatically establishes the applicability of article VIII. We see no such connection between the two provisions. The logical conclusion from petitioner's premise that article XI(1) does not apply to imputed interest is instead that such income is taxable at the rates prescribed in the Code. See *Maximov v. United States*, 373 U.S. at 51.

Petitioner finally argues: "The difference in the treatment of imputed interest under the domestic laws of the United States and Canada dictates that before such interest can be taxed, the issue must be negotiated and addressed by specific treaty language." According to petitioner, only Canada and not the United States taxed imputed interest at the time the Canadian treaty came into effect, and the Canadian system provides for a subjective "facts and circumstances" analysis in contrast to the objective process of section 483. Petitioner further notes that paragraph 2 of the contemporaneous protocol and section 519.102(a) of the regulations provide, respectively, as follows:

> 2. In the event of appreciable changes in the fiscal laws of either of the contracting States, the Governments of the two contracting States will consult together.
>
> * * * * * * *
>
> Sec. 519.102 Scope of secs. 519.101 to 519.120.—(a) The primary purposes of the convention, to be accomplished on a mutually reciprocal basis, * * * [include] the application of a limited rate of taxation to certain classes of income derived from within one of the contracting States by residents or corporations of the other contracting State * * *[20]

From all of this, petitioner deduces: "In order for this goal of mutuality to be effected, taxation by both countries must be implemented pursuant to the express terms of the Treaty, and cannot be changed by subsequent amendments of the internal laws of one of the countries unless such change is addressed through subsequent negotiations."

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[20] See *supra* note 4.

We need not respond in detail to every implication raised by the above argument but can dispose of the issue with a few simple principles. First and foremost, respondent's interpretation, not petitioner's, is the more faithful to the express terms of the Canadian treaty and to settled rules governing the relationship between treaties and the Internal Revenue Code. Second, even if Congress breached its duty under paragraph 2 of the protocol in enacting section 483,[21] Congress can abrogate a treaty provision by subsequent statute. See *Reid v. Covert*, 354 U.S. 1, 18 (1957) (Opinion of Justice Black), and cases cited therein. Third, paragraph 2 of the protocol only mandates that the Governments consult; a change in fiscal law does not affect the other provisions of the treaty.[22] Finally, the right of the United States to tax imputed interest at the reduced rate provided in article XI(1) is consistent with the mutuality objective expressed in section 519.102(a) of the regulations. Allowing both the United States and Canada to tax imputed interest, although under conceptually different domestic rules, does not undermine mutuality. The Canadian treaty by no means contemplates identical domestic tax systems. Cf. *Maximov v. United States*, 373 U.S. at 54.

Conclusion

Petitioner's motion for summary judgment will be granted with respect to the first issue and will be denied with respect to the second issue. Because triable issues of fact remain,

An appropriate order will be issued.

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[21] We make no finding concerning this issue but note that the addition of sec. 483 to the Code by the Revenue Act of 1964, Pub. L. 88-272, sec. 224, 78 Stat. 19, 77-79, could reasonably not be deemed an appreciable change in fiscal law.

[22] See *supra* note 21. This Court is, of course, powerless to enforce a provision such as par. 2. See *Filler v. Commissioner*, 74 T.C. 406 (1980).

DENNIS S. BROWN, ET AL., PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 29929–82, 2313–83,
3083–83, 3503–83.

On October 24, 1985, by order of Judge Perry Shields the opinion filed in this case on August 26, 1985, was withdrawn. Revised opinion filed December 18, 1985, appears at 85 T.C. 968.

SUE B. PACKARD, A.K.A. VIRGINIA S. WAINWRIGHT, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

RICHARD A. WAINWRIGHT, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 23163–82, 24088–82. Filed September 5, 1985.

Petitioners, then husband and wife, cash basis taxpayers, invested in a cattle-feeding program in late December 1971 through a subch. S corporation of which one of petitioners was the sole shareholder. Petitioners funded the investment in part with the proceeds of a bank recourse loan that was secured by a certificate of deposit purchased and pledged by the feed yard. The corporation prepaid and deducted feed expenses in 1971 although none of the feed was consumed in that year. In February 1972, a general partnership formed by petitioners purchased all of the stock of the corporation through a purported installment sale under sec. 453, I.R.C. 1954, the corporation was liquidated, and the partnership claimed a step-up in basis of the assets received from the corporation, including fully expensed feed. *Held*, the program in which petitioners invested was not a sham, but the form in which the transactions were cast was inconsistent with their true nature, and the step-transaction doctrine applies so as to disregard the corporation. *Held, further*, the cattle-feed expenditure was fully deductible in the year in which it was paid. *Held, further*, the partnership did not suffer a theft loss in 1973.

Sherin V. Reynolds, for the petitioner in docket No. 23163–82.

Kenneth B. Weckstein, for the petitioner in docket No. 24088–82.

Cynthia J. Mattson, for the respondent.

COHEN, *Judge*: In these consolidated cases, respondent determined deficiencies in Federal income tax of petitioners as follows:

Petitioner/docket No.	*Taxable year*	*Amount*
Sue B. Packard (a.k.a. Virginia S. Wainwright) Docket No. 23163–82	1971	$207,421.00
	FYE 2/1/72	[1]157,282.24
	1972	226,724.00
	1975	3,193.71
Richard A. Wainwright Docket No. 24088–82	1971	207,421.00
	1972	226,724.00
	1975	10,766.19

After concessions, we must decide the correct tax treatment of petitioners' investment in a cattle-feeding operation. Respondent claims that the total program was a sham, disputes the deductibility of a prepayment for feed, and attacks the use of a subchapter S corporation and a partnership formed by petitioners in order to defer the reporting of gains through an installment sale under section 453[2] and to secure additional deductions through a subsequent liquidation of the corporation. Finally, petitioner Wainwright claims a net operating loss resulting from an alleged theft of partnership funds by petitioner Packard.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations of facts and attached exhibits are incorporated herein by reference.

Petitioners Richard S. Wainwright (Wainwright) and Sue B. Packard (Packard), also known as Virginia S. Wainwright, were husband and wife during taxable years 1971 and 1972 and filed joint Federal income tax returns for those years. Petitioners were divorced in December 1973, and filed separate returns for 1973, 1974, and 1975. Petitioners filed their income tax returns for taxable years 1971 through 1975 using the cash method of accounting. Wainwright resided in Silver Spring, Maryland, and Packard resided in Boca Raton, Florida, when they filed their respective petitions in these cases.

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[1] Respondent has conceded the deficiency of $157,282.24 for fiscal year ending Feb. 1, 1972, against petitioner Packard as transferee of the assets of Queen Feeding & Livestock Co.

[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

On December 10, 1971, petitioners received a liquidating distribution from an electronics company that they founded in 1962. Wainwright, an electrical engineer, had managed the technical aspects of the company, while Packard had managed the financial affairs of the company and the family. Petitioners reported the liquidating distribution on their 1971 return as long-term capital gain of $735,961, which resulted in additional taxable income to them of $365,480.

In late 1971, petitioners explored investment possibilities in cattle feeding. Petitioners discussed an investment in cattle feeding with their attorneys, Arthur Schneck (Schneck) and Martin Todtman (Todtman). Although petitioners had invested previously in oil, stocks, bonds, and real estate, they had no experience in the cattle business.

An investment opportunity in a cattle-feeding program was made available to petitioners by Cornwall Investment Corp. (Cornwall). Although Cornwall's involvement in cattle feeding was primarily for its own account, it also offered the program to a limited number of clients, friends, and other individuals with whom it was associated. Petitioners had no prior association with Cornwall. The program was made available to petitioners, however, after preliminary discussions in late 1971 among Schneck and Todtman and Martin Blackman (Blackman), one of the principals of Cornwall. Petitioners did not participate in the preliminary discussions and neither met nor spoke with anyone from Cornwall until they met in Blackman's New York City office on December 17, 1971, to discuss further and finalize the transaction. Blackman, a tax attorney, had been involved in the cattle-feeding business since the early 1960's.

In general, the Cornwall program offered to petitioners called for the feeding of the cattle in three rounds over approximately 12 months, with one-third of the cattle contracted to be purchased and fed at one time. The use of three rounds of feeding minimized risks attributable to such factors as weather, disease, and market. Under the program, an investor would enter into a feeding contract with a local feed yard, usually Zimmerman Feed Yards, Inc. (Zimmerman), of Springfield, Nebraska. Zimmerman contracted with other feed yards to feed the cattle if it lacked sufficient space in its own feed yards. J.P. Latham (Latham) was president of Zimmerman. Latham and his wife were primarily responsible for the daily feeding of the cattle, and in consultation with personnel of Cornwall, for decisions relating to the purchase and sale of the cattle. Cornwall and Latham charged management and supervision fees, respectively, for their services. Under the Cornwall program, financing and other banking services were provided to investors by Omaha National Bank (ONB) of Omaha, Nebraska, of which Latham and Zimmerman had been long-standing customers.

Petitioners, Blackman, Robert Tanenbaum (Tanenbaum), also a principal of Cornwall, Schneck, and Todtman were present at the December 17, 1971, meeting. At the meeting, Blackman explained to petitioners the nature of the cattle-feeding business, the proposed transaction, its prospects for profit or loss, and the likely tax consequences. No written explanation of the Cornwall cattle-feeding program was made available to petitioners or other participants in the program. Petitioners received no written explanation of the economic results from previous Cornwall transactions.

The participants at the December 17 meeting discussed the purchase by Packard of the stock of a subchapter S corporation, the prepayment of feed by the corporation, and the resulting tax deduction to petitioners in the year of purchase for the amount of the prepaid feed expense. Petitioners were advised at the meeting that expenses such as labor and insurance were deductible in the year such expenses were incurred, and that the cost of cattle was a capital item. The participants also discussed the possibility of an installment sale in the following year of the stock of the subchapter S corporation and the subsequent liquidation of the corporation's assets into a partnership that could be formed by both petitioners to proceed with the cattle-feeding operations. Petitioners were advised of the tax consequences of an installment sale election under section 453.

Formation of Queen Feeding & Livestock Co.

At the December 17, 1971, meeting, and in accordance with the discussions during that meeting, Packard purchased, for $350,000, 1,000 shares of common stock of Queen Feeding & Livestock Co. (Queen), a Delaware corporation organized on December 14, 1971. Queen's stated purpose was to engage in feeding livestock.

Although Packard was the sole shareholder of Queen, petitioners considered the investment in the cattle-feeding program a joint investment.

Packard paid for the Queen stock in part with two checks totaling $140,000 from an account held jointly with Wainwright at Suburban Trust Co. of Wheaton, Maryland. Packard paid the balance of the purchase price with a $210,000 check dated December 17, 1971, drawn from a new account at ONB.

The source of the funds in the ONB account was a loan to Packard from ONB arranged by Cornwall and Zimmerman. The loan was evidenced by a demand note executed by Packard, dated December 17, 1971, in the principal amount of $210,000, with interest at a rate of 7¾ percent per annum. The note was presented to Packard by Blackman and signed in his office during the December 17, 1971, meeting. The note contained the following provision regarding collateral:

> 3. To secure the payment of this note and all other indebtedness or liability, direct or indirect, joint or several, absolute or contingent, now existing or hereafter acquired or contracted, of Borrower to Bank (hereinafter collectively designated "Obligations"), whether such Obligations are created directly or acquired by Bank by assignment or otherwise, Borrower hereby pledges to Bank and grants to Bank a security interest under the Uniform Commercial Code in the following described property (hereinafter collectively designated "Collateral") [Blank lines] and all property listed on the back hereof and all other property now or hereafter in the possession or control of Bank. Borrower agrees to deliver to the holder, immediately upon demand, additional Collateral should the holder deem itself insecure.

No specific property was designated as collateral on the face or the reverse of the note. Packard was personally liable for repayment of the note.

Prior to obtaining the loan, neither Packard nor Wainwright had financial dealings with ONB. Petitioners submitted no financial statements and had no direct contacts with ONB in obtaining the loan. The financing arrangement with ONB was available to all participants in the Cornwall program and consisted of the following transactions: ONB loaned to the investor 60 percent of the amount required for the purchase of feed; the bank loan was evidenced by a recourse note executed by the investor; proceeds of the loan and the balance of the amount to be invested in the cattle-feeding program were deposited into an account opened for the investor at ONB; thereafter, a check was drawn from the ONB account payable to the feed yard for the feed payment; the feed yard then purchased a time certificate of deposit in an amount equal to the loan and pledged the certificate of deposit as collateral for the loan. Under the arrangement, ONB agreed that the interest rate on the loan to the investor would be 4 percent over the amount being earned on the certificate of deposit pledged by the feed yard. ONB required a pledge of cattle and feed to finance the transaction.

During the years of petitioners' participation in the Cornwall program, 1971 through 1973, Marvin Rohn (Rohn) was an agricultural loan officer of ONB. Rohn was employed by ONB from 1961 to 1981. Rohn assisted David Johnson, a vice president of ONB.

On December 17, 1971, Packard consented to the election of Blackman as sole director of Queen and the corporation's adoption of a plan to issue section 1244 stock. Also on that date, Packard consented to Queen's election to be taxed as a small business corporation. By corporate resolution dated December 17, 1971, an account for Queen at ONB was authorized, and Blackman was elected president of Queen. The three checks written by Packard totaling $350,000 for the purchase of the Queen stock were transmitted by Blackman to Rohn and deposited in Queen's account at ONB. All documents dated December 17, 1971, were signed in Blackman's office the same date.

Queen obtained authorization to transact business in the State of Nebraska by application dated December 23, 1971. Latham was appointed Queen's registered agent in Nebraska.

As president of Queen, Blackman executed contracts and documents relating to the cattle transactions. Tanenbaum acted as accountant for Queen and maintained its checkbook.

In accordance with the discussions at the December 17, 1971, meeting, Queen entered into a written cattle-feeding agreement with Zimmerman. Under the terms of the agreement dated December 23, 1971, Zimmerman agreed to purchase for Queen approximately 5,235 head of cattle for an aggregate purchase price not to exceed $1,675,200. The agreement provided for delivery of the cattle at Zimmerman's feed yards in Springfield, Nebraska, to commence on December 23, 1971, and to be completed by November 1, 1972. With respect to feed, the agreement contained the following provision:

> (1) Owner hereby delivers feed to Feeder, and Feeder acknowledges receipt hereof of feed having a fair market value of $341,213.14 of the kind, quantity and quality evidenced by bona fide bill of sale attached hereto and marked Exhibit 1.

The feeding agreement fixed the price of feed. Under the terms of the agreement, a $8,750 downpayment was required on the cattle purchase, and a note and chattel mortgage for the balance of the purchase price was to be executed by Queen upon completion of the cattle purchase by Zimmerman. The note and chattel mortgage provided for payment of the balance of the purchase price of cattle out of the proceeds of the sale of cattle whenever sold, with no liability on the part of Queen beyond the proceeds of the sale of the cattle covered by the note and chattel mortgage. The agreement did not require prepayment of charges such as labor, veterinary fees, insurance, freight, and other operating costs. Under the agreement, proceeds of cattle sales would be distributed as follows:

> out of total net proceeds of sale, Feeder first shall be entitled to unpaid bills owing by Owner to Feeder, if any, under this agreement, and then to discharge the note and chattel mortgage * * * and thereafter to distribute to Owner the balance thereof.

Any unconsumed feed would be returned to Queen under the terms of the agreement. The agreement further provided that the agreement, note, and chattel mortgage were to be assigned by Zimmerman to ONB.

Two checks dated December 23, 1971, were drawn from Queen's account at ONB to the order of Zimmerman for the downpayment for cattle and for the feed payment in the amounts of $8,750 and $341,213.14, respectively, and were forwarded on that date by Blackman to Mr. and Mrs. Latham. These checks were paid by ONB on December 28, 1971.

The December 23, 1971, bill of sale for feed called for the following amounts of feed to be used in Queen's cattle-feeding operations:

224,164	bu	Corn	@	$1.15	bu	$257,788.60	
2,826,360	lbs	Molasses hay	@	38.00	ton	53,700.84	
94,200	lbs	Prairie hay	@	31.00	ton	1,460.10	
628,080	lbs	Protein	@	90.00	ton	28,263.00	[sic]
						341,213.14	

No cattle were purchased or fed in 1971 under the agreement between Queen and Zimmerman.

Approximately 75 percent of the amount of the feed purchase was allocated to corn. The monthly cash prices per bushel of No. 2 yellow corn on the Chicago grain market were as shown in table 1 on page 405; the monthly cash prices per bushel of No. 2 yellow corn on the Omaha grain market were as shown in table 2 on page 406.

The amount of feed purchased by Queen was based on petitioners' $350,000 investment in Queen stock, less the minimal downpayment on the cattle. Factors entering into the decision to have Queen purchase the feed in December 1971 included: ability to fix the price of feed for the entire feeding cycle, to assure adequate feed for the number of head of cattle to be fed over the next 12 months, to reserve feedlot space, and to enable petitioners to leverage the transaction.

On December 28, 1971, Zimmerman purchased a $210,000 time certificate of deposit, due October 30, 1972, at 3.75-percent interest, and pledged it as collateral for the $210,000 loan from ONB to Packard. ONB would not have made the loan to Packard without the certificate of deposit pledged by Zimmerman as collateral.

Queen filed a Form 1120S, U.S. Small Business Corporation Income Tax Return for the year December 14, 1971, through December 31, 1971, using the cash method of accounting. On its 1971 return, Queen reported no income and claimed deductions for feed purchased and taxes in amounts of $341,213 and $10, respectively. Queen reported its loss of $341,223 distributable to Packard, its sole shareholder.

On their 1971 joint return, Wainwright and Packard reported a total loss of $341,223 from Queen.

TABLE 1

CASH PRICES FOR CORN NO. 2 YELLOW - CHICAGO
(per bushel)

Year beginning *Oct.*	*Oct.*	*Nov.*	*Dec.*	*Jan.*	*Feb.*	*Mar.*	*Apr.*	*May*	*June*	*July*	*Aug.*	*Sept.*	*Average*
1945	118	118	118	118	118	121	121	139	145	218	194	191	143
1946	188	143	137	135	142	171	180	184	212	218	242	253	184
1947	244	250	264	274	226	235	236	234	234	215	200	188	233
1948	157	143	146	145	131	136	140	138	138	142	132	133	140
1949	125	117	133	132	134	137	145	151	150	157	155	155	141
1950	155	161	173	178	184	180	182	180	174	178	181	182	170
1951	181	186	196	195	185	184	184	186	184	183	183	178	185
1952	166	161	166	163	158	159	160	163	159	160	163	168	162
1953	149	149	158	157	157	158	158	161	163	163	164	165	159
1954	159	153	156	156	153	149	149	151	149	148	134	133	149
1955	125	121	129	128	130	135	150	154	156	158	160	161	142
1956	135	137	138	137	130	131	132	134	133	135	132	127	133
1957	121	119	119	115	116	119	130	134	137	136	136	128	126
1958	121	115	119	119	119	123	130	130	131	128	128	122	124
1959	115	113	112	117	115	117	122	123	122	121	120	117	118
1960	110	99	105	112	115	114	111	115	114	115	114	112	111
1961	112	112	111	109	110	112	114	117	115	114	111	113	112
1962	113	110	116	120	121	122	121	124	131	133	133	136	123
1963	124	117	123	124	122	124	126	129	127	124	126	129	125
1964	123	120	127	129	131	133	135	138	137	133	131	132	131
1965	123	116	124	132	131	128	128	131	133	143	149	146	132
1966	140	135	145	142	141	141	138	139	138	131	123	120	136
1967	117	110	114	113	115	117	116	119	115	113	108	109	114
1968	109	115	116	120	118	117	124	132	131	129	130	124	122
1969	121	118	119	126	126	124	128	132	137	138	146	152	131
1970	142	142	154	159	157	155	151	152	157	148	129	116	147
1971	110	107	122	122	121	126	126	128	125	129	129	140	124
1972	132	133	157	158	159	159	165	201	242	252	291	247	191
1973	237	250	268	290	313	299	269	270	293	335	363	355	295
1974	374	348	347	319	296	290	296	282	291	295	311	299	312
1975	274	258	259	262	270	268	268	284	296	296	284	277	215
1976	249	233	244	253	254	252	250	241	227	205	178	180	230

TABLE 2

CASH PRICES FOR CORN NO. 2 YELLOW - OMAHA
(per bushel)

Year beginning Oct.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Average
1964	123	123	127	127	128	130	132	130	129	128	123	123	127
1965	119	119	126	129	127	121	125	124	126	133	138	135	127
1966	133	134	136	133	131	131	127	130	131	128	118	116	129
1967	114	111	114	115	115	117	119	122	119	116	110	117	116
1968	118	118	117	120	119	121	125	129	126	123	122	117	121
1969	117	117	116	120	120	119	122	124	126	128	136	140	124
1970	134	134	143	146	146	144	143	145	148	141	124	115	139
1971	114	115	124	125	123	123	125	127	123	124	121	128	123
1972	128	134	149	156	155	149	151	184	225	232	271	237	180
1973	234	240	249	271	295	276	249	251	268	319	355	346	279
1974	363	346	336	307	279	275	285	281	284	292	312	295	305
1975	275	255	256	257	260	262	257	274	286				

Formation of D & S Investment Co.

On January 12, 1972, petitioners, as general partners, organized D & S Investment Co. (D & S), a general partnership with a principal place of business in Springfield, Nebraska. Under the terms of the partnership agreement, petitioners were to share equally in profits and losses. The agreement provided further that "No Partner, without consent of all other partners, shall * * * [u]se the name, credit, or property of the Partnership for any purpose other than a proper Partnership purpose." The partnership agreement provided its construction and the rights and liabilities of the partners would be governed by Nebraska law. Petitioners each contributed to D & S separate demand notes, dated January 12, 1972, in amounts of $17,500. These notes were never paid.

As partners of D & S, petitioners on January 12, 1972, appointed Blackman as the partnership's general manager and approved the purchase by D & S of all of the Queen stock for $385,000 to be paid in 15 annual installments. Petitioners also approved the complete liquidation of Queen, the continuance of the cattle-feeding business by D & S after the liquidation of Queen, and the distribution of Queen's assets to the partnership.

Packard and D & S entered into an agreement dated February 1, 1972, for the sale of 1,000 shares of Queen stock for $385,000, to be paid in 15 annual installments, with interest on the unpaid balance at the rate of 5 percent per annum, payable annually. D & S gave Packard a note, dated February 1, 1972, consistent with the terms of the sale agreement, in amount of $385,000.

On February 1, 1972, D & S adopted a plan of complete liquidation of Queen. Also on that date, as a result of the liquidation, D & S received the assets and liabilities of Queen, including the feed valued at $341,213.14, the cost of which had been deducted by Queen in its preceding taxable year. D & S allocated the basis of the property it received from Queen pursuant to section 334(a) as follows:

Feed	$341,213.14
Feeding contract	35,000.00
Miscellaneous	11.00
Subtotal	376,224.19 [sic]
Other assets	8,750.00
Cash	25.81
Total	385,000.00 [sic]

Queen filed Form 1120S for the taxable year January 1, 1972, through February 1, 1972, using the cash method of accounting, and reported no income or loss.

Of the participants in the Cornwall program during the 1971–73 feeding season, each of 14 participants, including petitioners, formed a subchapter S corporation, which was incorporated in Delaware and authorized to transact business in Nebraska. Each corporation entered into a cattle-feeding agreement dated December 23, 1971. Each corporation was subsequently liquidated after an installment sale of the stock to a related partnership.

Cattle-Feeding Transactions

The purchase and feeding of cattle commenced on February 16, 1972, with the first round of feeding. The third round of feeding was completed on February 13, 1973. In the three rounds of feeding, a total of 4,888 feeder steers were purchased and fed, and of the feed purchased in December 1971, $304,102.09 of feed was consumed. The steers were fed for an average of 115 days and gained an average of 1.89 pounds per day. The cattle were sold from May 1972 through February 1973, for a total price of $1,974,214.24, to such firms as Iowa Beef, Armour, M.B.P., Beefland, and Hormel. The fattened cattle sold for an average price of 36 cents per pound. During the period in which D & S was in operation, the price of choice slaughter steers fluctuated 10 cents, from a low of 33 cents per pound in November 1972 to a high of 43 cents per pound in February 1973.

Other than the December 17, 1971, meeting, petitioners had no meetings or communications, in person, by telephone, or otherwise, with Blackman during the cattle-feeding operation. Packard conferred with Tanenbaum occasionally by telephone. Petitioners did not actively participate in the cattle-feeding operation, but rather, they relied on Blackman and Tanenbaum, as well as their own attorneys, to manage their investment. Tanenbaum orally advised Todtman or Schneck of the results of each round of feeding as they became available. In turn, the attorneys advised petitioners by telephone of the timing of each round. Packard was not aware that she had suffered an economic loss on the investment until after the cattle-feeding operation had terminated.

The transactions in each round of feeding were as follows:

Round One

On February 16, 1972, Zimmerman sold 1,606 head of cattle to D & S for $527,500.23. Of Queen's $8,750 downpayment for cattle, $3,000 was applied to this sale, resulting in a net purchase price of $524,500.23. D & S executed a nonrecourse note in favor of Zimmerman in the amount of $524,500.23, and a chattel mortgage pledging all cattle and feed as security for the note. A financing statement covering "livestock, feed, contract and contract rights" was filed with the county clerk, Sarpy County, Nebraska, on March 7, 1972.

During round one, $101,645.66 of feed was consumed. As a result of round one, Zimmerman reported cattle sales of $659,086.04. After expenses and the amount applied to the chattel mortgage, D & S received a distribution of $2,849.60 from Zimmerman. Zimmerman retained $107,926.06.

Round Two

D & S purchased 1,295 head of cattle for $335,067.78, less $3,000 attributable to Queen's downpayment, for a net purchase price of $332,067.78 by bill of sale dated May 10, 1972. As in round one, D & S executed a nonrecourse note in the amount of the net purchase price, a chattel mortgage to secure the note, and a financing statement.

During round two, $88,363.10 of feed was consumed, cattle sales amounted to $435,560.68, and after expenses and the amount applied to the chattel mortgage, Zimmerman retained $78,105.45. D & S received no distribution from round two.

Round Three

D & S purchased 1,987 head of cattle for $723,623.11, less $2,750 attributable to Queen's downpayment, for a net purchase price of $720,873.11 by bill of sale dated October 24, 1972. As in the other rounds, D & S executed a nonrecourse note in the amount of the net purchase price, a chattel mortgage to secure the note, and a financing statement.

During round three, $114,093.33 of feed was consumed, cattle sales amounted to $879,567.52, and after expenses and the amount applied to the chattel mortgage, Zimmerman retained $120,463.73 and remitted $6,856.20 to D & S.

Post Cattle-Feeding Transactions

The following amounts of feed were unconsumed and purchased from D & S by Zimmerman on February 13, 1973:

25,160	bu	Corn	@	$1.18	bu	$29,688.80
253,000	lbs	Molasses hay	@	44.00	ton	5,566.00
41,250	lbs	Protein	@	90.00	ton	1,856.25
						37,111.05

A final remittance report dated February 13, 1973, was issued by Zimmerman to D & S summarizing the three rounds as follows:

Amounts previously retained	$306,495.24
Additional revenues and expenses:	
Veterinary supplies and services	(9,678.39)
Feed sold	37,111.05
Net remittance	333,927.90

On February 13, 1973, Zimmerman issued to D & S a check in the amount of $333,927.90 for the net remittance, and a check in the amount of $833.24 for three crippled steers.

On February 14, 1973, the $6,856.20 check from round three and the final remittance check for $333,927.90 from Zimmerman were deposited into the checking account of D & S at ONB. The following disbursements were made from the D & S account by checks dated February 14, 1973:

$42,000 to Cornwall for its management fee;
$19,250 to Packard for payment of interest from February 1, 1972, to February 1, 1973, on the installment note;
$25,666.67 to Packard for payment of principal on the installment note;
$256,596.84 to D & S.

Upon instruction from Todtman, Tanenbaum advised ONB to transfer $256,596.84 from the D & S account at ONB to a D & S account at Chemical Bank of New York (Chemical Bank). The $256,596.84 check was deposited into D & S account number 020098618 at Chemical Bank. Although that amount was initially credited to the D & S Chemical Bank account in April 1973, the credit was subsequently reversed due to a stop payment on the check by ONB. No further deposits were made in the D & S Chemical Bank account.

Packard paid the principal and interest on the loan at ONB by two checks dated March 6, 1973, in amounts of $210,000 and $19,663.76, respectively, from her personal account at Chemical Bank (number 020313691). The check for the interest was paid on March 8, 1973. The check for the principal was not paid until May 2, 1973.

On May 1, 1973, $256,596.84 was transferred by wire to Packard's personal account at Chemical Bank (number 020313691). The release of $256,596.84 from the D & S account at ONB came after the $210,000 loan was paid by Packard.

Although Wainwright made repeated inquiries about the transfer of the D & S funds into Packard's personal account, the $256,596.84 was never deposited in the D & S account at Chemical Bank.

By letter to Packard dated February 28, 1973, Tanenbaum advised that the sale of the partnership's cattle was complete and that "due to weather conditions affecting the weight gain and price of cattle, the results this year were not as good as the results last year." He summarized the economic and tax results of petitioners' cattle transactions as follows:

Total invested	$350,000.00
Net proceeds	301,613.51
Net cattle loss	48,386.49

The loss included the $42,000 management fee paid to Cornwall. The letter also set forth the following income tax consequences of petitioners' investment: 1971 subchapter S loss of $341,223, and 1972 and 1973 partnership losses of $33,879 and $49,507, respectively, resulting in total available ordinary deductions of $424,609. Tanenbaum further advised Packard that the gain on the sale of the Queen stock to D & S was reportable as ordinary gain in 15 equal installments of $25,082 for each year from 1973 through 1987. In addition, the letter included projections of net gain from the investment based on tax brackets of 50, 60, and 70 percent. Prior to that correspondence, no written results of the D & S cattle-feeding operations were communicated to petitioners.

D & S filed its partnership returns for 1972 and 1973 using the cash method of accounting. On its U.S. Partnership Return of Income (Form 1065) for the taxable year 1972, D & S reported a net loss of $33,879, distributable equally to petitioners. The net loss claimed for 1972 resulted from transactions in rounds one and two as follows:

Cattle sales		$1,094,647
Costs:		
Cattle:		
Round one	$527,500.23	
Round two	335,067.78	
Feed:		
Round one	101,645.66	
Round two	88,363.10	
Pro rata allocation of $35,000 purchase price	26,745.00	
	1,079,322.00	
Labor	25,468.00	
Interest	22,428.00	
Miscellaneous	1,308.00	1,128,526
		(33,879)

On Schedule L of its 1972 return, D & S showed assets as of the end of the taxable year as follows:

Cash		$2,869
Inventories		821,767
Other current assets:		
Due from feeder	$186,032	
Notes receivable	35,000	
Feed received in liquidation	61,326	282,358
Total assets		1,106,994

On their joint return for 1972, petitioners reported their distributive shares of the 1972 loss claimed by D & S. Petitioners elected to report the income realized on the sale of the Queen stock on an installment basis under section 453, and reported that no payments were received in the year of sale (1972).

On its Form 1065 for 1973, D & S reported a net loss of $68,762, distributable equally to petitioners. The claimed net loss resulted from transactions in round three as follows:

Cattle sales		$879,567
Costs:		
Cattle:		
Round three	$723,623.11	
Feed:		
Round three	114,093.33	
Remainder of original amount of feed	37,121.56	
Pro rata allocation of $35,000 purchase price	8,255.00	
	883,093.00	
Labor	14,111.00	
Interest	14,254.00	
Vet	9,678.00	
Miscellaneous	3,049.00	
Management fee	42,000.00	966,185
Sale of feed		37,111
		(49,507)
Interest on installment note		19,255
		(68,762)

On their individual income tax returns for 1973, petitioners each deducted $34,381 as his or her share of the loss claimed by D & S for the taxable year 1973.

On her 1973 individual income tax return, Packard reported income of $25,082 from the installment sale of Queen stock to D & S. Packard failed to report the $19,250 interest payment she received from D & S on the installment note, for which D & S claimed a deduction on its 1973 return. Packard claimed a deduction of $19,664 for interest paid on the $210,000 ONB loan.

Subsequent to 1973, no further payments were made by D & S on the installment sale and neither Packard nor Wainwright reported income from the sale for Federal income tax purposes.

Wainwright filed an amended return for 1973 carrying back a loss of $128,298, which he reported was produced by the transfer of D & S funds in the amount of $256,596.84 to Packard's personal account.

In his statutory notices of deficiency, respondent disallowed petitioners' claimed distributive share of the Queen loss for 1971 to the extent of the $341,213 prepaid feed deduction on the grounds that there was no business purpose for the prepayment and the deduction resulted in a material distortion of income. As an alternative position, respondent determined that petitioners recognized short-term capital gain of $341,213 as a result of the liquidation of Queen after the transfer of the Queen stock to D & S, which was actually a contribution to capital under section 721.

Respondent further determined that the cost of cattle sold by D & S during 1972 was $26,745 less than the amount shown on its return, and, accordingly, disallowed petitioners' claimed distributive shares of the D & S loss to that extent. Respondent also made an automatic medical expense adjustment.

Respondent has not determined a deficiency for either petitioner for 1973 because of the bar of the statute of limitations.[3]

OPINION

The issues in this case concern the deductions, if any, to which petitioners are entitled from their investment through Queen and D & S in the Cornwall cattle-feeding program. Respondent challenges petitioners' loss deductions on numerous grounds. Respondent's primary position is that the transactions lacked economic substance, were entered into solely for tax avoidance, and should be disregarded in their entirety for Federal income tax purposes as shams. Respondent also argues that the transactions were implemented pursuant to a preconceived plan, the steps of which should be integrated for tax purposes. Alternatively, respondent argues that the prepaid feed deduction resulted in a material distortion of income and that the purported installment sale of the Queen stock was in reality a contribution to the capital of D & S. Respondent's other arguments include his contention that the transactions entered into by Queen and D & S were not activities engaged in primarily for profit, and his position that the prepaid feed deduction should be disallowed to the extent of $210,000 (the amount of the loan to Packard from ONB) because there was no payment of this amount by a cash-basis taxpayer. Finally, if we determine that the prepaid feed expense was allowable in full for 1971, respondent asserts the alternative position that the purported sale of the Queen stock was in reality a contribution to the capital of D & S, and that the liquidation of Queen resulted in short-term capital gain to petitioners of $341,213 in 1972.

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[3] Obviously this fact cannot affect our decision. It is set forth only for completeness.

Petitioners assert that the transactions were bona fide, had economic substance, were entered into with a reasonable objective for profit, and, accordingly, should be respected for tax purposes.

The final issue deals with Wainwright's claim that the transfer of funds from the D & S account to the personal account of Packard constituted a theft, and as such, he is entitled to carry back and carry over his share of the resulting net operating loss incurred by D & S in 1973.

1. Sham-Transaction Theory

Petitioners were faced with a substantial tax liability upon the liquidation of their electronics company in late 1971. Within weeks of the liquidation and in the last 2 weeks of 1971, petitioners invested in a cattle-feeding program that generated tax losses that essentially eliminated the additional income derived from the unrelated capital gain. Respondent contends that the coincidence in amount of taxable gain and acquired deduction and the lack of economic substance to the cattle-feeding operation compel the conclusion that the entire program was a sham that must be disregarded for tax purposes.

The investment device chosen by petitioners centered around the special tax treatment afforded to farmers with regard to tax accounting for farm expenditures.[4] Farmers are given the option of using either the cash or inventory method of accounting under section 1.471–6(a), Income Tax Regs.[5] In conjunction with section 162, which allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, farmers are permitted to deduct as necessary expenses all amounts actually expended in carrying on the business of farming, including the purchase of feed and other costs connected with raising livestock. Sec. 1.162-12(a), Income Tax Regs.[6] These special privileges have been recognized by the Supreme Court as an historical concession for farmers:

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[4] No contention is made that petitioners are not "farmers" under sec. 1.471–6(a) or 1.162–12(a), Income Tax Regs.

The changes made by Congress under the Tax Reform Acts of 1976 and 1984 with regard to farming syndicates are not applicable to the years in issue. See Tax Reform Act of 1976, Pub. L. 94–455, sec. 207, 90 Stat. 1536; Tax Reform Act of 1984, Pub. L. 98–369, sec. 91, 98 Stat. 494, 601.

[5] Sec. 1.471–6(a), Income Tax Regs., provides in part:

> (a) A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used * * *

> The sacrifice in accounting accuracy under the cash method represents an historical concession by the Secretary and the Commissioner to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a simplified accounting procedure. [*United States v. Catto*, 384 U.S. 102, 116 (1966).]

Petitioners had no prior experience in the cattle-feeding business and they were not actively involved in the program in which they chose to invest. The substantial tax benefits were without doubt a motivating factor in petitioners' decision to engage in the transactions as structured by the promoters of the Cornwall program. Thus, these circumstances justify careful scrutiny of the arrangements that were employed and the manner in which those arrangements were implemented in our assessment of the economic substance of the transactions in issue. *Owens v. Commissioner*, 64 T.C. 1, 16–17 (1975), affd. in part and revd. in part 568 F.2d 1233 (6th Cir. 1977).

Artifices that are engaged in solely for favorable tax consequences and are devoid of economic substance have been disregarded by the courts, in appropriate circumstances, under the sham transaction doctrine. See, e.g., *Knetsch v. United States*, 364 U.S. 361 (1960); *Moore v. Commissioner*, 85 T.C. 72 (1985); *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981); *Derr v. Commissioner*, 77 T.C. 708 (1981).

In *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978), the Supreme Court examined the problem of allocating depreciation deductions in a sale-leaseback case, approved the transaction as structured, and articulated the following test to determine whether a transaction is, for tax purposes, a sham:

> Where * * * there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory

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[6] Sec. 1.162-12(a), Income Tax Regs., provides in pertinent part:

(a) *Farms engaged in for profit.* A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. * * * The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay * * *

> realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties. [435 U.S. at 583–584.]

As the test was restated in *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d 89, 91 (4th Cir. 1985), affg. in part and revg. in part 81 T.C. 184 (1983), in order to treat a transaction as a sham,

> the court must find that the taxpayer was motivated by no business purposes other than obtaining tax benefits in entering the transaction, and that the transaction has no economic substance because no reasonable possibility of a profit exists. [Citations omitted.]

The first prong of the sham inquiry, the business purpose inquiry, is a subjective test and simply concerns the motives of the taxpayer in entering the transaction. *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 92; see *Knetsch v. United States*, 364 U.S. 361 (1960). A taxpayer's failure to establish that a transaction was motivated by a business purpose rather than by tax avoidance is not conclusive, however, that the transaction was a sham. Rather, if an objective analysis of the transaction indicates that a reasonable possibility of profit existed apart from tax benefits, the transaction will not be classified as a sham. *Frank Lyon Co. v. United States*, 435 U.S. at 583–584; *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 203 & n. 17.

Undoubtedly the obvious tax shelter potential was a motivating factor in petitioners' decision to participate in the cattle-feeding program. We are not convinced, however, that the transactions were not also motivated by a business purpose. Petitioners had received substantial funds from the sale of their business, and their testimony that they were looking for a means of investing those funds so as to preserve or enhance them is credible.

Irrespective of petitioners' subjective motivation for entering into the transaction, if we find that the underlying transaction was supported by economic substance, we will not disregard it as a sham. See *Frank Lyon Co. v. United States*, 435 U.S. at 583–584; *Rice's Toyota World, Inc. v. Commissioner*, 752 F.2d at 92.

The precise degree of business motive or economic substance that must be present in a transaction for tax recognition is not clearly defined. *Rice's Toyota World, Inc. v. Commissioner*, 81 T.C. at 202. As we noted in *Rice's Toyota World*, however, the presence of a genuine indebtedness supported by an actual investment is strong evidence of economic substance. 81 T.C. at 202.

In the instant case, petitioners made an actual cash investment of $140,000. Packard also executed a $210,000 recourse note. D & S purchased and fed 4,888 feeder steers, which were sold for a total purchase price of $1,974,214.24.

This is not a case where there was no way in which petitioners could have benefited economically from the transaction. Cf. *Rice's Toyota World, Inc. v. Commissioner, supra; Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221 (1981). The parties stipulated that the price of choice slaughter steers fluctuated 10 cents during the period in which D & S was in operation—from a low of 33 cents per pound in November 1972 to a high of 43 cents per pound in February 1973. The fattened cattle sold for an average price of 36 cents per pound. Tanenbaum testified that the D & S cattle-feeding operation would have shown a profit if the beef had sold for 1 cent more per pound. Tanenbaum also testified that the cattle-feeding business had been profitable overall in the previous year and that there had been no reason to believe it would not also be profitable in the subsequent year. Blackman, a veteran of 10 years in the cattle-feeding business, testified at length regarding the factors that affect profitability in that business:

> A. Well, profitability is effected, obviously, by the price at which feed is purchased, price at which cattle is purchased, the price at which feed is sold. The variables come in due to factors of weather and there's a great variety of weather factors.
>
> You have—in the winter, you have the frost and snow which is a hazard to the cattle. You have the thaws which convert the cattle feed lots in effect into seas of mud in which it's very difficult for the cattle to gain weight because they slush around in the mud. And that was a factor in one of these cycles.
>
> You have the summer weather. You have conditions of severe heat and drought that are adverse. Of course, you can have the favorable weather also. You also have the supply and demand factor as to how many other ranges and feed lots have animals on the hoof. You have the factors of disease.

> You have the factor of international politics. If there is grain sale to—a new grain sale or additional competition in the grain market that will effect the price of feed and the price of cattle. You have the profit factor of the extent of which foreign cattle is being imported into the country.
>
> You have factors of domestic politics. At one period, we had a factor of price control which I think just followed these cycles that the Wainwrights were in.

Blackman testified that the variables were discussed when petitioners were contemplating their entry into the program.

On the evidence in this case and under the applicable authorities, we do not conclude that petitioners' cattle-feeding program was a sham for tax purposes.

2. *Step-Transaction Theory*

Although we have determined that the transactions were not shaped solely by tax-avoidance considerations, and have not been shown to be shams, we must still determine whether the form in which the transactions were cast was inconsistent with their true nature. "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945). See *Gregory v. Helvering*, 293 U.S. 465 (1935).

Respondent takes the position that the formation of Queen, the prepayment of feed by Queen, the formation of D & S, and the purported installment sale of Queen stock to D & S, followed by the immediate liquidation of Queen, were preconceived steps in a single plan of action. Respondent asserts that "there was no purpose for the creation of Queen other than to set the stage for the installment sale that would give rise to the 15-year deferral," and that there was no business purpose for the prepayment of feed. Thus he asks us to apply the step-transaction doctrine to disregard the creation of Queen and all steps taken by Queen, including the prepayment of feed and the installment sale, and to recognize D & S as the entity actually conducting the feeding operation, so as to disallow the entire subchapter S loss in 1971 and collapse the transaction into 1972 and 1973 when the actual feeding took place.

Although we agree that application of the step-transaction doctrine is proper in this case, our application does not produce the result outlined by respondent.

Where an interrelated series of steps are taken pursuant to a plan to achieve an intended result, the tax consequences are to be determined not by viewing each step in isolation, but by considering all of them as an integrated whole. See *D'Angelo Associates, Inc. v. Commissioner*, 70 T.C. 121, 129 (1978); *Redwing Carriers, Inc. v. Tomlinson*, 399 F.2d 652, 658 (5th Cir. 1968); *Atlee v. Commissioner*, 67 T.C. 395 (1976); *King Enterprises, Inc. v. United States*, 189 Ct. Cl. 466, 418 F.2d 511, 516 (1969). As the Supreme Court cautioned in *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938): "A given result at the end of a straight path is not made a different result because reached by following a devious path."

The twisted path followed by petitioners took them through a series of closely related steps that culminated in the formation of a general partnership in whose name the feeding operation was actually conducted. These events occurred within an interval of less than 2 months. Packard purchased the Queen stock on December 17, 1971. Queen entered into the cattle-feeding agreement with Zimmerman and purchased feed on December 23, 1971. Queen conducted no other activities during its existence. On January 12, 1972, petitioners organized D & S. On February 1, 1972, Packard and D & S entered into the agreement for the purported installment sale of the Queen stock, which terminated Queen's status as a small business corporation. Also on February 1, 1972, D & S adopted a plan for the liquidation of Queen, and D & S received the assets and liabilities of Queen. The purchase and feeding of cattle did not commence until February 16, 1972.

Blackman testified that the participants at the December 17, 1971, meeting discussed the "possibility" of the formation in the following year of a partnership that could purchase the Queen stock through an installment sale, liquidate the corporation and receive its assets, and then proceed with the cattle-feeding operations. On the record before us, the series of events outlined by Blackman at the December 17, 1971, meeting, and actually carried out by petitioners, who had no subsequent meetings with any of the Cornwall personnel, seems more than a "possibility." We are convinced that the intent from the outset was to conduct the cattle-feeding operation in the partnership form. Indeed, this was the end result—no cattle were purchased or fed until after Queen had been liquidated and its assets distributed to D & S. The fact that the other participants in the program during the years of petitioners' participation commonly engaged in identically structured transactions lends further support to our conclusion that the structure of the cattle-feeding operation was carried out pursuant to a preconceived plan developed by the Cornwall promoters.

Petitioners presented no evidence of a valid business reason for entry into the transaction via the subchapter S structure and conducting the actual feeding operations in the partnership form upon immediate liquidation of the subchapter S corporation. Wainwright testified that the decision to form D & S in early 1972 was made because "someone suggested that a partnership was a proper form for a business transaction." He could not recall at trial who presented the partnership documents to him for signature, nor where they were executed. Packard testified that Schneck and Todtman advised petitioners to form the partnership and that the documents were sent to petitioners by their attorneys in January 1972. At trial, Wainwright stated: "D & S was to be a vehicle for investments and we were to purchase the stock in Queen as a first business operation. We have substantial other businesses which could have been incorporated within that framework." Such general testimony does not establish a business reason for the formation of the formally discrete steps taken by petitioners.

On the basis of the record before us and the inferences to be drawn therefrom, we conclude that Queen was formed as a vehicle through which petitioners hoped to achieve significant tax advantages. Initially, petitioners seized upon the liberal tax accounting treatment made available to farmers for prepaid feed expenses. By consenting to Queen's election to be treated as a small business corporation, Packard insured that the loss incurred by Queen for the prepayment of feed would be passed through to her as the corporation's sole shareholder, and as such, would offset other unrelated income. Under the guise of an installment sale, petitioner's tax-avoidance aims were twofold: first, to step up the basis in the cattle-feeding assets received by D & S upon the liquidation of Queen, including the feed previously expensed by Queen, and thereby secure additional deductions; and second, to take advantage of the provisions of section 453, so as to defer the gain on the sale over a period of 15 years.

Queen served no business purpose and performed no function other than to enable petitioners to stage the purported sale and liquidation. We therefore apply the step-transaction doctrine to recast the transaction as though petitioners had formed D & S from the outset to purchase the feed and conduct the feeding operations. We believe that form reflects the true substance of the transaction. See *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Jacobs v. Commissioner*, 21 T.C. 165 (1953), affd. 224 F.2d 412 (9th Cir. 1955). The result of our application of the step-transaction doctrine is that D & S has no basis in feed after 1971. Thus, in calculating its costs deductible from proceeds of sale in 1972, D & S cannot include any amounts attributable to the purported purchase of Queen's assets, including fully expensed feed.

In describing transactions of Queen in the discussion below, we therefore treat them as if D & S had been formed in 1971 and the transactions had been conducted in its name, rather than that of Queen.

3. *Deductibility of Prepaid Feed Expenses in 1971*

In support of their position that they are entitled to the claimed deductions for the prepayment of feed expenses in 1971, petitioners rely on a line of cases generally supporting the deductibility of prepaid feed expenses, especially our decision in *Van Raden v. Commissioner*, 71 T.C. 1083 (1979), affd. 650 F.2d 1046 (9th Cir. 1981). See *Frysinger v. Commissioner*, 645 F.2d 523 (5th Cir. 1981), affg. a Memorandum Opinion of this Court; *Cravens v. Commissioner*, 272 F.2d 895 (10th Cir. 1959), revg. 30 T.C. 903 (1958).[7]

In *Van Raden*, the taxpayers invested as limited partners in a cash-basis partnership cattle-feeding operation in December

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[7] See *Bandes v. Commissioner*, T.C. Memo. 1982-355; *Heinold v. Commissioner*, T.C. Memo. 1979-496; *Haynes v. Commissioner*, T.C. Memo. 1979-240; *De La Cruz v. Commissioner*, T.C. Memo. 1978-8.

1972. The partnership purchased a 1-year supply of feed and some cattle in the last few days of the 1972 taxable year. Because Rev. Rul. 75–152, 1975–1 C.B. 144, dealt specifically with the issue involved, and respondent's position tracked the three-part test of that ruling, we examined, in the manner set forth in that ruling, the issue of whether the limited partners were entitled to deduct the cost of feed in the year of purchase, or whether they were limited to a deduction in the year of consumption.[8] *Van Raden v. Commissioner*, 71 T.C. at 1096. The ruling provided that a prepayment for feed is deductible only if (1) the expenditure is a payment and not merely a deposit; (2) the prepayment is for a business purpose and not merely for tax avoidance; and (3) the deduction does not result in a material distortion of income.

As in the instant case, respondent disallowed the taxpayers' deductions in the year of purchase in *Van Raden* on the grounds that there was no business purpose for the prepayment and the deduction caused a material distortion of income. The first part of the three-part test, whether the expenditure was a payment or a deposit, was not an issue in *Van Raden*.

A variety of approaches have been used by the courts to evaluate the deductibility of prepaid expenses by cash-basis taxpayers, depending on the expense item in question. In *Mann v. Commissioner*, 483 F.2d 673, 676 (8th Cir. 1973), revg. a Memorandum Opinion of this Court, the Court of Appeals noted:

> There is clearly no common thread or governing principle which rationalizes and renders predictable the results concerning deductibility of advance payments in general. However, special theories and practices have developed which govern the tax treatment of advance payments for livestock feed.

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[8] Rev. Rul. 79–229, 1979–2 C.B. 210, amplified and superseded Rev. Rul. 75–152, 1975–1 C.B. 144, but did not change the three-part test. Revenue rulings are merely statements of the Commissioner's litigating and administrative position and do not have the force of law. *Estate of Lang v. Commissioner*, 64 T.C. 404 (1975), affd. in part and revd. in part 613 F.2d 770 (9th Cir. 1980); *Stubbs, Overbeck & Associates, Inc. v. United States*, 445 F.2d 1142, 1146–1147 (5th Cir. 1971). The tests set forth in these rulings have been applied, but not necessarily endorsed, however, by most courts discussing the prepaid feed expense issue. See *Van Raden v. Commissioner*, 71 T.C. 1083 (1979), affd. 650 F.2d 1046 (9th Cir. 1981); *Frysinger v. Commissioner*, 645 F.2d 523 (5th Cir. 1981), affg. a Memorandum Opinion of this Court; *Bandes v. Commissioner*, T.C. Memo. 1982–355. See also Ward, "Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling 75–152," 53 Tex. L. Rev. 1119 (1975).

In *Owens v. Commissioner*, 64 T.C. 1, 17 (1975), affd. in part and revd. in part 568 F.2d 1233 (6th Cir. 1977), we observed that the issue of prepaid feed expenses is sui generis, and, recognizing the confused history surrounding the issue, we stated that "Perhaps the only eternal guideline or principle that can be gleaned from prior decisions is that each case must be decided in light of its particular facts and circumstances." 64 T.C. at 16.

In *Van Raden*, this Court applied a variant of the three-part test set forth in respondent's revenue ruling and found that despite the favorable tax consequences that flowed from the prepayment, the primary purpose of the prepayment was to secure a year's supply of feed at the lowest possible price. We also found that the taxpayers satisfied the distortion of income test after concluding that the test is satisfied by a "substantial legitimate business purpose." 71 T.C. at 1106.

We applied the approach we adopted in *Van Raden* with respect to prepaid intangible drilling and development costs in *Keller v. Commissioner*, 79 T.C. 7, 28 (1982), affd. 725 F.2d 1173 (8th Cir. 1984). As we noted in *Keller*:

> Unquestionably, the first part of respondent's test, i.e., that the expenditure must be a payment rather than a refundable deposit, is a sine qua non for deductibility in any context. See, e.g., the discussion in *Sandor v. Commissioner*, 62 T.C. 469 (1974), affd. 536 F.2d 874 (9th Cir. 1976), a prepaid interest case. With regard to the second and third parts of respondent's analysis, we are unwilling to hold that business purpose for prepayment is an independent requirement for deductibility. Rather, as we observed in *Van Raden v. Commissioner*, 71 T.C. at 1099, "There is some overlapping of the business purpose test and the distortion of income test." Insofar as cash basis taxpayers are concerned, the two concepts are so inextricably interwoven that the material distortion analysis mandated by section 446(b) must include a substantial consideration of the business purpose aspects of the transaction. In *Van Raden*, we stated that "a substantial legitimate business purpose satisfies the distortion of income test." 71 T.C. at 1106. * * * [79 T.C. at 28.]

In evaluating the deductibility of the December 1971 prepayment by Queen, we apply our approach set forth in *Van Raden* and *Keller*:

Payment or Deposit?

As we observed in *Keller*:

> The term "payment" has a special meaning for tax purposes. It does not mean a simple transfer of money by a taxpayer. *Ernst v. Commissioner*, 32 T.C. 181 (1959). A transfer of money pursuant to a binding contract also is not enough. *Owens v. Commissioner*, 64 T.C. 1, 18 (1975), affd. in part and revd. in part 568 F.2d 1233 (6th Cir. 1977). A payment occurs only when the taxpayer's money is "irretrievably out of pocket." *Ernst v. Commissioner, supra* at 186.
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> If, by express, implied, or customary terms, a taxpayer retains a unilateral power to get the money back, then the money transfer is a "deposit" rather than a payment. *Owens v. Commissioner, supra*; *Lillie v. Commissioner*, 45 T.C. 54 (1965) (Court reviewed), affd. 370 F.2d 562 (9th Cir. 1966); *Mann v. Commissioner*, 483 F.2d 673 (8th Cir. 1973), revg. a Memorandum Opinion of this Court; *Shippy v. United States*, 308 F.2d 743 (8th Cir. 1962). See Ward, "Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling 75-152," 53 Tex. L. Rev. 1119, 1123-1145 (1975). This rule prevents the possibility of taxpayer abuse which would occur if, in year one, a taxpayer transfers money to a third party and takes a deduction and, in year two, he compels a return of the money and cancels the transaction supporting the deduction.
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> [79 T.C. at 29; fn. ref. omitted.]

We further stated that "The deposit vs. payment inquiry properly focuses only on the unilateral power of a taxpayer to compel the return of the prepaid amounts." 79 T.C. at 46. Zimmerman's bill of sale dated December 23, 1971, states that specific amounts and kinds of feed in the amount of $341,213.14 were sold to Queen, and the feeding contract of that same date recites that the feed was delivered by Queen to Zimmerman, who acknowledged its receipt. Queen's check in the amount of $342,213.14, also dated December 23, 1971, payable to Zimmerman, was paid by ONB on December 28, 1971. Also on December 28, 1971, Zimmerman purchased a certificate of deposit to secure the $210,000 loan from ONB to Packard. The feeding contract contained no provision entitling Queen to a refund at the close of the transaction for any unconsumed feed. At the close of the three rounds of feeding, Zimmerman purchased $37,111.05 worth of unconsumed feed from D & S.

Respondent contends that the $341,213.14 prepayment was a deposit rather than a payment under the theory that $210,000 was not actually paid in 1971 or used for the purchase of feed. Respondent maintains that the proceeds of the loan never left the bank, but rather were used by Zimmerman to purchase the certificate of deposit, which secured the ONB loan to Packard. Respondent asserts that no more than $131,213.14 was available for feed at any time during the entire program. In support of his argument, respondent points to the amounts retained by Zimmerman after rounds one and two of feeding. Respondent maintains that these amounts were retained by Zimmerman in order to purchase feed for the following round.

Based on the terms of the feeding contract, the bill of sale, and the fact that Queen's check for the entire amount of feed was paid by the bank on December 28, 1971, we conclude that at the time of payment, Queen had irrevocably committed itself to the purchase of specific items of feed within a specific year and could not compel the return of any of the prepaid amounts. Furthermore, we do not believe the resale of the excess feed to the feed yard suggests a deposit. Such disposition reflects a valid business judgment in view of the perishable nature of feed and the expense that would have been incurred in transporting it elsewhere for sale.[9]

Respondent also contends that the loan arrangement with ONB was a "circle of paper money" and petitioners should not be entitled to a deduction to the extent that the prepaid expense was paid out of the loan proceeds.

In support of his argument, respondent relies on our decision in *Burns v. Commissioner*, 78 T.C. 185 (1982). In *Burns*, the taxpayers purchased working interests in oil and gas leases and entered into turnkey drilling and completion contracts and other agreements with the sellers-promoters. The taxpayers paid in cash the full amounts of intangible drilling and development costs allowable under section 1.612–4, Income Tax Regs. In our consideration of whether the taxpayers were entitled to deduct those amounts in full we examined the underlying financing arrangements among the taxpayers, the banks, and the promoters to determine whether the IDCs were actually incurred by the taxpayers. The "financing packages" arranged by the promoters enabled the taxpayers to borrow one-half of the amounts stated in the drilling contracts through nonrecourse loans from the banks. To induce the banks to provide the financing, the loans were fully collateralized by certificates of deposit pledged by the promoters. The financing packages also included agreements between the taxpayers and the promoters providing for repayments of the loans out of 50 percent of the net profits from production. As the notes were retired, the pledges of the certificates of deposit were reduced. If the promoters were not otherwise compensated as they desired upon repayment of the notes in full, they could force a sale of the entire working interest and receive 50 percent of the sales proceeds. We concluded that in economic substance the parties had created a 50-percent net profits interest in favor of the promoters, and, therefore, because the taxpayers in effect had paid only 50 percent of the IDCs, they were entitled to deduct only that amount.

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[9] *De La Cruz v. Commissioner*, T.C. Memo. 1978–8.

We held further in *Burns* that the agreements among the parties were not genuine multiple-party transactions. See *Frank Lyon Co. v. Commissioner*, 435 U.S. 561, 583–584 (1978); *Burns v. Commissioner*, 78 T.C. at 213. We examined the role of the banks in the financing packages and noted that "The use of a third party in a given transaction may be made in such a way as to give the appearance of importing substance to the transaction but, in reality, the interjection of the third party may be no more than 'window dressing.' " 78 T.C. at 212. As in the present case, the bank in *Burns* made no credit checks on the borrowers nor did they require financial statements. We concluded in *Burns* that the banks were used by the promoters to conceal the true economic substance of the transaction. 78 T.C. at 213.

The situation in *Burns* is distinguishable, however, from that now before us. In *Burns*, we emphasized that the agreements placed the promoters in the position of demanding 50 percent of the net profits after repayment of the loans.

> If, upon full repayment of the loans, petitioners regained the interests they had in proceeds from the sale of oil and gas prior to the loans, we would not be so inclined to question the substance of the transaction. But this is not what happens. The promoters are in a position to demand and receive the share of production formerly committed to repayment of the loans. This demonstrates that the promoters held a 50-percent net profits interest when the package of agreements was entered into and that the interest continues in them until the sale of the leaseholds. Even then, the promoters receive 50 percent of the net proceeds of the sale of the leaseholds in the guise of a 50-percent commission.
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> As to the 50-percent portion of the IDCs which were disallowed, petitioners, in substance, only lent their names to be used on the promissory notes, except in the case of CPC where other wells were pledged as collateral for the losses. This additional security was merely "window dressing" as to the

> loans because the banks, at all times, held certificates of deposit equal to the unpaid balances on the loans. When the loans were repaid, petitioners continued to receive only 50 percent of the proceeds from the sale of oil and gas.
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> [78 T.C. at 211.]

In contrast, petitioners were entitled at all times to the proceeds from the sale of the cattle, even though ONB may have been looking first to the proceeds of cattle sales as a source for repayment of the loan to Packard.

This case is also to be distinguished from those cases where a true lending transaction is lacking due to the contingency of repayment upon the success or failure of the business transaction. See *Graf v. Commissioner*, 80 T.C. 944, 951 (1983). Packard's obligation to ONB was not contingent on future profits. She was personally liable for the debt, and repayment was subject to no contingency.

Although Packard's loan was fully collateralized with a certificate of deposit purchased and pledged by Zimmerman, Packard was the actual borrower and the primary obligor on the loan. Cf. *Estates of Helliwell v. Commissioner*, 77 T.C. 964 (1981). This is not a case, as was *Burns*, where the use of a third party is no more than "window dressing."

We therefore hold that the loan was a genuine multiple-party transaction with economic substance and that petitioners paid the full prepaid feed expense of $341,213.

Business Purpose or Tax Avoidance?

The focus of the business purpose versus tax-avoidance test is the timing of the deduction. *Van Raden v. Commissioner*, 71 T.C. at 1096. Because business purpose is a question of fact, we must look to all of the facts and circumstances to determine whether petitioners have proved a business purpose for the December 1971 feed purchase. *Van Raden v. Commissioner*, 71 T.C. at 1097.

Generally, the distinguishing factor for the allowance or disallowance of the deduction is whether the taxpayer has established a reasonable expectation of receiving some business benefit from the prepayment. *Lillie v. Commissioner*, 45 T.C. 54, 62 (1965), affd. per curiam 370 F.2d 562 (9th Cir. 1966); *Shippy v. United States*, 308 F.2d 743, 747 (8th Cir. 1962); *Ernst v. Commissioner*, 32 T.C. 181 (1959).

A business purpose exists if the prepayment fixes maximum prices for feed, secures an assured feed supply, or secures preferential treatment in anticipation of a feed shortage. *Van Raden v. Commissioner*, 71 T.C. at 1101; *Ernst v. Commissioner*, 32 T.C. at 186.[10] The parties here stipulated that the feeding agreement dated December 23, 1971, fixed the price of feed.

In *Van Raden*, testimony of the manager of the cattle-feeding operations and corroborating statistical evidence established that the feed was purchased in December because the price was lowest at that point, and the price was fixed by purchasing a year's supply in advance, thereby establishing a business purpose for the purchase at that time. *Van Raden v. Commissioner*, 71 T.C. at 1097–1099.

Securing the feed at the lowest possible price was not represented to be the primary purpose of the prepayment in this case. Petitioners rely on the testimony of Blackman, who managed the cattle-feeding program, to prove a business purpose for the prepayment. Blackman testified that the purchase was made in December to fix the price for the entire feeding cycle and to assure the availability of the full amount of feed necessary to complete the feeding. According to Blackman's testimony, the prepayment also enabled Queen to reserve feeding space with the Zimmerman feed lot and enabled petitioners to obtain financing for the cattle and thereby benefit from leveraging. Blackman testified that although lower feed prices in December would have been a good reason to buy feed at that time, that would have been only one of many factors that compelled the purchase in December. He testified further:

> We were making a deal in December that we thought would result in feeding commencing immediately. It happened based on judgment as things developed that we did not commence feeding until February.
>
> So the fact that if we had the advantage of foresight we might have saved a couple of dollars by deferring the purchase to February. It was not a fact that would have been available to us when we anticipated beginning feeding very shortly.

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[10] See also *Heinold v. Commissioner*, T.C. Memo. 1979–496.

In order to close this transaction in December, we had to prepay the feed and pledge the feed to the bank.[11]

Respondent contends that the purpose of the decision to buy feed in December 1971, rather than in 1972 when it was actually consumed, was tax avoidance, not business benefit. The obvious tax advantages of the transaction and our disregard of an identity for Queen separate from D & S do not, however, taint the entire program. It appears that petitioners were overreaching in attempting to defer taxable income beyond the time permitted by the well-established rules governing prepaid feed expenses by the use of an artificial installment sale, and to obtain additional deductions through a stepped-up basis in the fully expensed feed through the corporate liquidation. Nonetheless, we must evaluate the prepaid feed aspect of the transaction on its own merit, and we must decide that issue on the evidence and not on the basis of suspicion.

The uncontradicted evidence that the purchase was appropriate to the business of Queen (i.e., D & S) cannot be ignored. The evidence of the trend in the price of corn, which accounted for approximately 75 percent of the feed purchased by Queen, is inconclusive. Neither that data nor any other evidence impeaches Blackman's claim that he and his associates used their best judgment on when to purchase feed. The businessman is allowed discretion to make business judgments. *Van Raden v. Commissioner*, 71 T.C. at 1101; *Clement v. United States*, 217 Ct. Cl. 495, 580 F.2d 422, 427 (1978). For these reasons, we decline to hold that the primary purpose of the prepayment was tax avoidance.

Distortion of Income

As a cash-basis taxpayer, Queen paid for the cattle feed and deducted the prepaid feed expense in that year in accordance with its method of accounting. Sec. 461; secs. 1.471–6(a) and 1.162–12(a), Income Tax Regs. Respondent contends that the prepayment resulted in a material distortion of income, relying upon section 446(b),[12] which gives the Commissioner discretionary power to require a recomputation of income if the taxpayer's method does not clearly reflect income. Respondent's determination will generally not be overturned in the absence of evidence of abuse of discretion. *Resnik v. Commissioner*, 66 T.C. 74, 78 (1976), affd. 555 F.2d 634 (7th Cir. 1977); *Sandor v. Commissioner*, 62 T.C. 469, 477 (1974), affd. per curiam 536 F.2d 874 (9th Cir. 1976). The taxpayer bears a heavy burden to overcome a determination of the Commissioner in this area. *Keller v. Commissioner*, 79 T.C. at 38; *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 284 (1967), citing *Commissioner v. Hansen*, 360 U.S. 446 (1959), and cases subsequent to it.

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[11] See the Commissioner's position in Rev. Rul. 75–152, 1975–1 C.B. 144, which states that whether the prepayment was a condition imposed by the seller and whether such condition was meaningful should be taken into consideration in determining whether there was a business purpose for the prepayment. This statement is also contained in Rev. Rul. 79–229, 1979–2 C.B. 210.

In *Van Raden*, we rejected the taxpayers' argument that the discretionary power under section 446(b) is not available to the Commissioner when dealing with farmers who use the cash method of accounting. 71 T.C. at 1102–1103. Accord *Clement v. United States*, 217 Ct. Cl. 495, 580 F.2d 422, 427 (1978). See also *Keller v. Commissioner*, 79 T.C. 7 (1982), affd. 725 F.2d 1173 (8th Cir. 1984); *Sandor v. Commissioner, supra.*

In *Frysinger v. Commissioner*, 645 F.2d 523, 526 (5th Cir. 1981), affg. a Memorandum Opinion of this Court, the Court of Appeals recognized the Commissioner's broad powers under section 446(b), but noted his lack of success in using his discretionary authority to challenge prepaid farm deductions, "principally because of the special treatment traditionally granted farmers under the tax regulations." In affirming our decision for the taxpayer, the Court of Appeals stated:

> We emphasize that our holding is limited to the facts in this case. We do not hold the Commissioner can never exercise his discretion under section 446(b) to disallow a prepaid feed deduction by a farmer. Rather we hold that where the taxpayer is a farmer covered by the special provisions allowing farmers to take current deductions for feed expenses, where the prepayment is for a business purpose and not merely tax avoidance, and where it is in line with normal business practice and not unreasonable, the Commissioner cannot use his discretionary authority to vitiate the benefits granted the taxpayer by his own regulations merely because the taxpayer's method may

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[12] Sec. 446 provided in pertinent part:

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

> otherwise result in a distortion of income. If "passive farmers" are to be treated differently, the change must come from Congress, as it has under IRC sec. 464, which now requires certain investment farmers to defer feed expenditure deductions at least until the feed is used or consumed. [645 F.2d at 528.]

Whether an accounting method materially distorts or clearly reflects income is a question of fact. *Van Raden v. Commissioner*, 71 T.C. at 1104; *Resnik v. Commissioner*, 555 F.2d at 636; *Sandor v. Commissioner*, 62 T.C. at 484. In support of his claim that the prepayment resulted in a material distortion of income, respondent notes that the prepayment was the sole expense of Queen, and Queen had no income. He claims that the distortion continued in 1972 because the installment sale allowed D & S to take additional losses without offsetting income, and that the distortion would have continued if the program had been carried out by petitioners. Respondent also points out that at the individual taxpayer level, petitioners' unrelated income was essentially eliminated by the loss resulting from the prepayment, yet petitioners subsequently disregarded the income side of the transaction. Respondent urges us to apply the distortion of income test at the shareholder level if distortion is not found at the entity level.

We held in *Van Raden* that section 446(b) applies to prepaid feed expenses at the partnership level for the reasons we expressed in *Resnik v. Commissioner*, *supra*, and we declined to examine the distortion of income test at the partner level.[13] 71 T.C. at 1103–1104 & n. 4. In this case, petitioners invested in the cattle-feeding program through a subchapter S corporation, which is treated as an entity distinct from its shareholders. We have treated the payment as if it had been made by the partnership. That petitioners obtained tax benefits from the loss is beside the point, and examination of the distortion of income test at the individual level is therefore inappropriate. See *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir. 1984), affg. 78 T.C. 471 (1982); *Van Raden v. Commissioner*, 71 T.C. at 1112 (concurring opinion of Judge Tannenwald).

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[13] In *Resnik v. Commissioner*, 66 T.C. 74 (1976), affd. 555 F.2d 634 (7th Cir. 1977), we held that sec. 446(b) must first be applied at the partnership level. Because we found the prepaid interest deduction caused a material distortion of the partnership's income, it was not necessary to examine distortion at the partner level. The test was applied at both levels in *Clement v. United States*, 217 Ct. Cl. 495, 580 F.2d 422 (1978).

Respondent argues that the purchase of feed in December 1971 caused a material distortion of income because the feed was on hand for a period longer than 1 year. Section 1.461-1(a)(1), Income Tax Regs., provides that an expenditure may not be deductible in the taxable year in which it is made if it results in the creation of an asset having a useful life extending substantially beyond the close of the taxable year. As we have stated repeatedly, cattle feed is not a period cost, with which this regulation relates, but rather, a product cost, the exhaustion of which depends upon the number of cattle and their rate of consumption, not the passage of time. *Van Raden v. Commissioner*, 71 T.C. at 1107–1108; *Frysinger v. Commissioner*, 645 F.2d at 527–528.[14]

Blackman testified that the expenditure was calculated to meet the feeding needs for 1 year. Furthermore, the feeding contract required Zimmerman to complete feeding by November 1, 1972. It was apparently anticipated at the time of purchase that the feed would be consumed within the period of 1 year.

In determining whether the prepaid feed expense created a material distortion of the partnership's income in *Van Raden*, we said:

> Because the method of accounting and the nature of the trade or business are so interdependent, we conclude that the distortion of income must not be examined in a vacuum but in light of the business practice or business activities which give rise to the transaction which the Commissioner has determined must be accorded a different accounting treatment. For example, material distortions of income may occur if the sales force of a business is more successful in December than in January, yet such a distortion would not require adjustment to clearly reflect income because the distortion resulted from the business activity itself. Should the result be different if the taxpayer purchases a year's supply of its primary cost item at its lowest cost consistently from year to year? We do not think so. In short, a substantial legitimate business purpose satisfies the distortion of income test. We recognized this implicity in *Sandor v. Commissioner, supra.* See *Stokes v. Commissioner*, 22 T.C. 415 (1954); *Maple Leaf Farms, Inc. v. Commissioner*, 64 T.C. 438 (1975); *Hi-Plains Enterprises, Inc. v. Commissioner*, 60 T.C. 158 (1973), affd. 496 F.2d 520 (10th Cir. 1974). [71 T.C. at 1105–1106.]

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[14] *Bandes v. Commissioner*, T.C. Memo. 1982-355; *Heinold v. Commissioner*, T.C. Memo. 1979-496; *Haynes v. Commissioner*, T.C. Memo. 1979-240.

Although the inventory method would undoubtedly produce a greater degree of exactness in the computation of taxable income, the regulations expressly permit farmers to use the cash method. In light of this historical concession to farmers and our finding that a valid business purpose existed for the 1971 feed purchase, we conclude, following our decision in *Van Raden*, that petitioners are entitled to deduct in 1971 the cattle-feed expenditures paid in that year.

In view of the rationale for our decision and the fact that an appeal will not be to the Ninth Circuit Court of Appeals, we need not consider the applicability of the "one-year rule" enunciated by that circuit in *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980), revg. 69 T.C. 605 (1978), and followed in *Commissioner v. Van Raden*, 650 F.2d 1046 (9th Cir. 1981), affg. 71 T.C. 1083 (1979).[15]

4. Wainwright's Theft Loss Claim

Wainwright claims that D & S suffered a net operating loss of $256,596.84 in 1973 as a result of Packard's retention of partnership funds in that amount. His claim is based on the transfer of proceeds from the partnership's cattle-feeding operation in amount of $256,596.84 from the D & S account at ONB in Omaha to Packard's personal account at Chemical Bank. Wainwright argues that the transfer was a theft of partnership funds, for which D & S may claim a theft loss under section 165, and that he is entitled under section 172 to carry back and carry over his share of that net operating loss.

Petitioner Wainwright bears the burden of proving his entitlement to a net operating loss deduction by establishing that D & S was entitled to the claimed theft loss deduction. *Welch v. Helvering*, 290 U.S. 111 (1933); *New Colonial Ice Co. v.*

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[15] The "one-year rule" allows a full deduction in the year of payment where an expenditure creates an asset having a useful life of 1 year or less. *Commissioner v. Van Raden*, 650 F.2d 1046, 1050 (9th Cir. 1981), affg. 71 T.C. 1083 (1979); *Zaninovich v. Commissioner*, 616 F.2d 429, 432 n. 6 (9th Cir. 1980), revg. 69 T.C. 605 (1978). As stated by the court in *Zaninovich*:

> "While the "one-year rule" is strictly applied to allow a full deduction in the year of payment where an expenditure creates an asset having a useful life beyond the taxable year of twelve months or less, it is not applied in the same manner in the other direction. Where an expenditure creates an asset having a useful life beyond the taxable year of more than twelve months, the "one-year rule" has been used as a guidepost only, and not as a rigid rule requiring automatic capitalization of every expenditure which creates an asset having a useful life in excess of one year. [Citations omitted.]"

Helvering, 292 U.S. 435 (1934); Rule 142(a), Tax Court Rules of Practice and Procedure.

The determination of whether a theft loss has been sustained depends upon the law of the jurisdiction where the loss occurred, in this case the law of the State of Nebraska. *Monteleone v. Commissioner*, 34 T.C. 688, 692 (1960).

Under the terms of the D & S partnership agreement, petitioners were to share equally in profits and losses. The agreement provided further that a partner was restricted from using partnership property "for any purpose other than a proper Partnership purpose," without the consent of all other partners. Construction of the agreement and the rights and liabilities of the partners were to be governed by Nebraska law.

Under Nebraska law:

> (1) A partner is co-owner with his partners of specific partnership property holding as a tenant in partnership.
>
> (2) The incidents of this tenancy are such that:
>
> (a) A partner * * * has an equal right with his partners to possess specific partnership property for partnership purposes; but he has no right to possess such property for any other purpose without the consent of his partners.
>
> [Neb. Rev. Stat. sec. 67-325 (1981).]

Wainwright's contention that D & S suffered a theft loss is not supported by the facts. Petitioners considered their cattle-feeding investment as a joint investment, and Wainwright shared in the deductions attributable to it. Petitioners considered the $210,000 ONB loan as a joint liability despite the fact that Packard was the sole obligor on the note. Under the form of the transaction adopted by petitioners, D & S was liable to Packard for $385,000 for its purchase of the Queen stock. At trial, Wainwright testified:

> Q. Okay. And isn't it correct that you knew that the $256,000 was supposed to be used to pay Virginia for the stock purchase?
>
> A. I knew Mrs. Wainwright was at that time—she was to receive monies over a period of time, yes. That was the 15 year framework.
>
> Q. Okay. And the $256,000 would form the basis for her receiving those monies? In other words isn't it correct that the $256,000 was supposed to stay in D and S's account, be invested and paid out to Mrs. Wainwright?
>
> A. The monies that came out of the cattle feeding operation, I believe belong to D and S as a result of the absorption of Queen. So, yes.

* * * * * * *

> Q. * * * when I asked you how else was that note—note supposed to get paid off, you made reference to not only Mrs. Wainwright's funds, but all of yours too. And my question to you is, if she had done that and paid off the $210,000 note with funds—with your joint funds that you had back then in 1972, would you have complained?
>
> A. It was a business transaction. We were in a partnership so why should I complain.

There is no evidence that the funds were used for other than a partnership purpose. The funds were used to satisfy the $210,000 loan and part of the purported installment obligation owed to Packard. Wainwright participated in the design and implementation of the investment program. His present claim appears to arise out of a subsequent domestic dispute rather than a genuine partnership loss. He is not entitled to a net operating loss deduction.

We have considered all other arguments of the parties and find them unpersuasive. To reflect the foregoing and concessions by the parties,

Decisions will be entered under Rule 155.

EDWIN RICHARD BELL AND DORIS VALERIE BELL, PETITIONERS V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 16913–83, 26082–84. Filed September 5, 1985.

Under the facts, it is *held*:

1. Petitioners were not entitled to certain claimed charitable contributions.
2. Allowable business expenses were determined.
3. Additions under sec. 6653(a), I.R.C. 1954, determined.
4. Award of damages to the United States under sec. 6673 was appropriate. Application of said section in this case was not an unconstitutional infringement of P's First Amendment rights.

Peter R. Stromer, for the petitioners.
Donna J. Rice, for the respondent.

OPINION

KÖRNER, *Judge*: In these consolidated cases, respondent determined deficiencies in income tax and additions to tax against petitioners as follows:

		Additions to tax	
Year	*Deficiency*	*Sec. 6653(a)(1)*[1]	*Sec. 6653(a)(2)*
1979	$1,883	$94	0
1980	8,002	400	0
1981	7,867	393	To be determined
1982	[2]1,018	0	0

The issues which the Court must decide are as follows:

(1) Whether petitioners are entitled to claimed deductions for the years in issue for charitable contributions, in the respective amounts of $6,027, $25,627, $22,877, and $2,396;

(2) Whether petitioners are entitled to a claimed deduction for employee business expenses for the year 1982 in the amount of $3,008;

(3) Whether petitioners are liable for additions to tax under section 6653(a) for the years 1979 through 1981; and

(4) Whether under the facts of this case the Court should award damages in favor of the United States under section 6673.

Some of the facts herein were stipulated, and such stipulation, together with accompanying exhibits, is incorporated herein by this reference.

At the time of filing their petitions herein, petitioners were residents of Pacifica, California. Petitioners filed joint Federal income tax returns for each of the years 1979 through 1982.

For convenience, our remaining findings and opinion will be grouped together on the issues to which they relate.

1. The Charitable Contributions Issue

The Universal Life Church, Inc., of Modesto, California (hereinafter ULC, INC.), issued a charter to petitioners in 1979 to establish a local congregation of that church. During the years in issue, ULC, INC., held exempt status from Federal income taxes under the provisions of section 501(c)(3).[3] In their joint income tax returns for 1979, 1980, and 1981, petitioners claimed charitable deductions in the respective amounts of $6,027, $25,627, and $22,877. For the year 1982, petitioners claimed a charitable contributions deduction in the amount of $2,396, as a carryover to that year of an unused charitable contribution in that amount from the year 1981 (presumably under the provisions of section 170(d)). In his statutory notices of deficiency for the years 1979, 1980, and 1981, respondent disallowed the claimed deductions on the grounds, inter alia, that such amounts had not been paid during the taxable years. For the year 1982, respondent's statutory notice of deficiency did not disallow the claimed charitable contributions carryover, but respondent, in his answer filed herein to the petition for that year, affirmatively raised the issue.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

[2] In his answer with respect to this year, respondent claimed an increased deficiency in the amount of $1,954, for a total of $2,972.

Although not revealed by their income tax returns for the respective years, which were introduced in evidence, petitioners contend that their claimed contributions were made to ULC, INC., a qualified charitable donee, and were made in cash. Other than the brief statement of petitioner Edwin Bell on the witness stand that petitioners had given to ULC, INC., in the amounts as stated in their tax returns for the years 1979 through 1981, however, there is no other proof in this record that any amount was given to anyone. Since petitioners contend the contributions were made by cash, no canceled checks were proffered. No bank statements were offered which would show the alleged contributions flowing into a bank account under the control of ULC, INC., nor was there any other admissible evidence proffered which would corroborate petitioner Edwin Bell's bare-bones and self-serving testimony.[4]

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[3] ULC, Inc.'s exempt status was revoked on Sept. 4, 1984. Announcement 84–90, 1984–36 I.R.B. 32.

[4] At trial, petitioners sought to introduce into evidence alleged "receipts" from ULC, Inc., showing contributions by petitioners in amounts different (and larger) for each year than those contended for by petitioners herein. Petitioners' witness Robert Imbeau, who described himself as a member of the board of directors of ULC, Inc., authenticated his signature on the form for 1979, but not on the 1980 and 1981 forms. The witness testified that said receipts were prepared from the regularly kept books and records of ULC, Inc., and under his supervision, and were supplied to donors to evidence their contributions. Further examination of the witness, however, revealed that the "records" of ULC, Inc., which were the basis and the foundation of the proffered receipts were documents prepared by petitioners' local congregation, and were not records kept in the ordinary course of business by ULC, Inc., at all. Such alleged underlying documents were not offered in

Petitioners had the burden of proof for the years 1979, 1980, and 1981 to establish that they were entitled to the deductions disallowed by respondent. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). They failed completely to carry this burden of proof.

With respect to the year 1982, since disallowance of the claimed carryover deduction in that year from the year 1981 was first raised by respondent in his answer to the petition for that year, technically the burden of proof as to this issue was upon respondent. Rule 142(a). However, our holding that petitioners failed to carry their necessary burden of proof to establish the claimed amount of charitable contributions made in the year 1981 amounts to a negative determination of that fact, viz, that such claimed contribution was not made. *Fairmont Aluminum Co. v. Commissioner*, 22 T.C. 1377 (1954), affd. 222 F.2d 622 (4th Cir. 1955), cert. denied 350 U.S. 838; *Stern & Stern Textiles, Inc. v. Commissioner*, 26 T.C. 1000 (1956), affd. 263 F.2d 538 (2d Cir. 1959), cert. denied 361 U.S. 831. The effect of such a determination with respect to the year 1981 necessarily means that there was no unused charitable contributions carryover which petitioners could utilize in 1982. We accordingly sustain respondent for all years with respect to the charitable contributions issue.

2. The Business Expense Issue

In the year 1982, petitioner Edwin Bell was employed as a union representative by Operating Engineers Local Union No. 3, of San Francisco, California. His duties, inter alia, included going to various locations within the union's territory to discuss union business with employers, union members, and/or those wishing to become union members, either through organizing an employer's place of business or otherwise. Edwin found it convenient on many occasions to discuss such business with these people at lunch or dinner meetings, because such

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evidence. We have repeatedly held that ULC, Inc., and its various chapters or congregations are not a single organization for tax purposes, but are separate. *Hall v. Commissioner*, 729 F.2d 632 (9th Cir. 1984), affg. T.C. Memo. 1982-337; *Davis v. Commissioner*, 81 T.C. 806 (1983), affd. by unpublished opinion 767 F.2d 931 (9th Cir. 1985), and cases cited therein. The "receipts" were accordingly refused admission into evidence as inadmissible hearsay. They were clearly not within any of the exceptions of rule 803 or 804 of the Federal Rules of Evidence. *Kalgaard v. Commissioner*, T.C. Memo. 1984-283, affd. 764 F.2d 1322 (9th Cir. 1985); *Davis v. Commissioner*, *supra*; *Hall v. Commissioner*, *supra*.

people were more readily available and such meetings did not infringe on their normal working hours. In the joint income tax return for 1982, Edwin claimed unreimbursed[5] employee business expenses in connection with his union employment as follows:

(a)	Dinners and drinks	$649
(b)	Lunches	496
(c)	Gifts and organizing expenses	333
(d)	Business w/other unions	261
(e)	Telephone and telegraph	77
(f)	Trade journals	96
(g)	Tickets, et al	34
(h)	Advertising	206
(i)	Union contributions	600
(j)	Flowers - deceased members	58
(k)	Stationery and postage	171
(l)	Automobile expenses	27
	Total	3,008

At trial, Edwin admitted that he had no form of documentation or other substantiation to support the claimed expenses in items (e) through (l) in the above list, and we therefore hold that he has failed to substantiate such expenses as required by section 162 and section 1.162–17, Income Tax Regs.

With respect to items (a) through (d) in the above list, Edwin testified that they were all included in a contemporaneous diary which he kept, and the diary was offered and received in evidence. It consisted of a spiral diary or notebook, separated into each day of the year, to which Edwin stapled a receipt stub from the bar or restaurant which was patronized, showing the date and amount of the charge, and with further notations by Edwin showing the persons entertained.

Although the diary maintained by Edwin shows expenditures for food and drink on the dates indicated, and at specific restaurants or bars, together with the names of the persons entertained, so as to be a satisfactory documentation of lunches, dinners, and drinks within the requirements of section 1.274–5(b) of respondent's regulations, there is nothing in the diary to support the claimed items of "gifts and organizing expenses" and "business w/other unions" (items (c) and (d) above). We accordingly disallow such items for lack of substantiation, but we will allow items (a) and (b), in the total amount of $1,145 as claimed by Edwin. Compare *Moylan v. Commissioner*, T.C. Memo. 1968–15; *Lickert v. Commissioner*, T.C. Memo. 1964–47.

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[5] Edwin testified that he received an expense allowance from his employer of $75 per week, but that such allowance was reported in his taxable income, presumably as part of the Form W-2 wages reported by the Union. No evidence to the contrary appearing, we accept Edwin's testimony on this point.

3. Additions to Tax Under Section 6653

For the years 1979, 1980, and 1981, respondent determined that petitioners were liable for the 5-percent addition to tax provided by section 6653(a)(1), for "negligence or intentional disregard of rules or regulations (but without intent to defraud)." In addition, for the year 1981, respondent determined that additions to tax should be made under section 6653(a)(2).[6] That subsection provides for an addition to tax in an amount equal to 50 percent of the interest payable under section 6601 with respect to the portion of the underpayment for a year which is due to negligence or intentional disregard of rules and regulations for the period beginning on the last day for payment of the underpayment.

With respect to respondent's additions to tax under section 6653(a)(1), the burden of proof to show error in respondent's determination was upon petitioners. *Bixby v. Commissioner*, 58 T.C. 757 (1972); Rule 142(a).

So far as the additions to tax under section 6653(a)(1) are concerned, petitioners have failed to carry their burden of proof to show any error on the part of respondent. Indeed, the record herein demonstrates the contrary, in two respects. First, petitioners argue that they complied with all applicable rules and regulations regarding the substantiation of their claimed contributions to ULC, INC., and proffered alleged receipts from that organization to prove the fact and the amount of their contributions. However, as we have discussed above herein, such alleged receipts were not admissible to substantiate the claimed contributions, since the facts surrounding the creation of these alleged receipts cast serious doubt upon their reliability. Second, and more important, respondent's regulations in force during the years 1979, 1980, and 1981 clearly required petitioners to disclose in their returns the identity of the charitable organization to which the claimed contributions were made. Sec. 1.170A-1(a)(2), Income Tax Regs. No such required disclosure was made by petitioners in the returns which they filed for these years.

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[6] The cited subsection is effective for calendar years beginning with 1981. Pub. L. 97–34, sec. 722(b)(1), 95 Stat. 342.

So far as the addition to tax for the year 1981 under the provisions of section 6653(a)(2) is concerned, petitioners' entire underpayment for each year was attributable to their claimed charitable contribution deductions. We therefore conclude that for purposes of section 6653(a)(2), all of petitioners' underpayment for 1981 was attributable to negligence and we therefore sustain the addition to tax imposed thereunder.

4. Award of Damages Under Section 6673

For the years 1979, 1980, and 1981, covered by docket No. 16913-83 herein, respondent urges that damages should be awarded in favor of the United States under the provisions of section 6673.[7]

A review of the record herein shows that such an award of damages is clearly justified. This Court has been faced with numerous cases, such as this one, with factual situations not significantly different, involving attempts by taxpayers to use the "pretext of a church to avoid paying their fair share of taxes, * * * [and to] resort to the courts in a shameless attempt to vindicate themselves." *Miedaner v. Commissioner*, 81 T.C. 272, 282 (1983). Such cases have uniformly been held by this Court to be entirely without merit, and by now, the continued assertion of these frivolous and meritless claims can no longer be considered to be serious efforts by bona fide taxpayers to vindicate a legitimate position. They are, in short, frivolous. See *Larsen v. Commissioner*, 765 F.2d 939 (9th Cir. 1985), affg. an order of dismissal of this Court; *Kalgaard v. Commissioner*, 764 F.2d 1322 (9th Cir. 1985), affg. T.C. Memo. 1984-283. The volume of frivolous cases of this type, of which petitioners' is one, have added to the overwhelming caseload in this Court, and have cost both this Court as well as respondent considerably in additional time and effort in order to dispose of them. As the Court of Appeals for the Fifth Circuit stated, "Appellants' contentions are stale ones, long settled against them. As such they are frivolous." See *Lonsdale v. Commissioner*, 661 F.2d 71, 72 (5th Cir. 1981), affg. a Memorandum Opinion of this Court.

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[7] Sec. 6673 provides:

"Whenever it appears to the Tax Court that proceedings before it have been instituted or maintained by the taxpayer primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless, damages in an amount not in excess of $5,000 shall be awarded to the United States by the Tax Court in its decision. Damages so awarded shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Secretary and shall be collected as a part of the tax."

Whether or not petitioners herein were aware of the total lack of merit in their claims when they filed their petition is not controlling. Prior to the time this case came to trial, the record herein shows that respondent had advised petitioners repeatedly that their claims were without merit, and had warned petitioners that if they persisted in their frivolous appeals, respondent would seek to invoke damages against them under section 6673. Petitioners ignored these warnings.

Petitioners argue vigorously in opposition to the imposition of any damages herein under section 6673, contending that the imposition of such damages is unconstitutional, in that it infringes upon the petitioners' rights under the First Amendment of the Constitution.[8] This argument approaches the same level of frivolity as petitioners' underlying claims themselves.

Section 6673 in its present form was enacted by the Tax Equity and Fiscal Responsibility Act (TEFRA), Pub. L. 97-248, section 292, 96 Stat. 572. It makes no attempt to infringe upon the right of any citizen who, acting seriously and in good faith, wishes to petition this Court for redress of grievances which he has against the Commissioner. As we said in *Hatfield v. Commissioner*, 68 T.C. 895, 899 (1977), however,

> Any citizen may resort to the courts whenever he or she in good faith and with a colorable claim desires to challenge the Commissioner's determination; but that does not mean that a citizen may resort to the courts merely to vent his or her anger and attempt symbolically to throw a wrench at the system * * *

In *Connor v. Commissioner*, 770 F.2d 17 (2d Cir. 1985), the court stated: "A taxpayer has no constitutional right to bring frivolous lawsuits."

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[8] As pertinent herein, the First Amendment provides:

"Congress shall make no law * * * abridging * * * the right of the people * * * to petition the Government for a redress of grievances."

The rights quaranteed to the citizen by the First Amendment to the Constitution are important and fundamental, but they are not absolute. They may not be used to subvert and destroy those very rights which the amendment was designed to safeguard. Many years ago, in a case involving First Amendment rights of free speech, Mr. Justice Holmes put it very well:

> But the character of every act depends upon the circumstances in which it is done * * * The most stringent protection of free speech would not protect a man in falsely shouting fire in a theatre and causing a panic. It does not even protect a man from an injunction against uttering words that may have all the effect of force * * * The question in every case is whether the words used are used in such circumstances and are of such a nature as to create a clear and present danger that they will bring about the substantive evils that Congress has a right to prevent. It is a question of proximity and degree. * * * [*Schenck v. United States*, 249 U.S. 47, 52 (1919).]

The right of petitioners to come to this Court to petition their Government for the redress of grievances does not include the right to attempt to bog down the functioning of this Court and subvert the orderly administration of justice. When faced with this situation, this Court, as well as other courts, has the right to take remedial action, both inherently and as authorized by Congress. See *Larsen v. Commissioner, supra*, and *Kalgaard v. Commissioner, supra* (both involving frivolous appeals of the type involved herein); *Sparrow v. Commissioner*, 748 F.2d 914 (4th Cir. 1984); *Tatum v. Regents of Nebraska-Lincoln*, 462 U.S. 1117 (1983). The Bill of Rights is designed to guarantee legitimate rights of all citizens, but it is not a suicide pact. As we said in *Abrams v. Commissioner*, 82 T.C. 403, 412 (1984):

> The direction of this nation's highest court is crystal clear—that no court should permit frivolous or groundless appeals, not only in discrimination suits but in any other area of litigation, including Federal income taxation. The language of amended section 6673 is equally clear.
>
> Here, petitioner has instituted these proceedings and has asserted as his defense to the Commissioner's determinations nothing but frivolous and groundless contentions. Petitioners with genuine controversies were delayed while we considered this case.

On this record, we conclude that petitioner's position for the years 1979, 1980, and 1981 was entirely without merit, and, even if it could be said that the petition was not instituted initially on frivolous grounds, its maintenance in the face of overwhelming contrary authority and in the fact of repeated warnings by respondent constitutes a clear showing that it was "maintained by the taxpayer primarily for delay" within the meaning of section 6673. We accordingly award damages to the United States under section 6673 in the amount of $5,000, in docket No. 16913–83.

Decision will be entered for the respondent in docket No. 16913–83.

Decision will be entered under Rule 155 in docket No. 26082–84.

ESTATE OF RICHARD B. BAUMGARDNER, JUNE BAUMGARDNER GELBART (FORMERLY JUNE E. BAUMGARDNER), PERSONAL REPRESENTATIVE, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 7435–81. Filed September 11, 1985.

P paid estate tax and interest thereon in installments, pursuant to sec. 6166A, I.R.C. 1954. The Commissioner determined a deficiency and P filed a petition with the Tax Court. The parties subsequently agreed that there was no deficiency and that P had in fact overpaid its estate tax. The Commissioner contends that the Tax Court, in its determination of an overpayment, has no jurisdiction to consider P's interest payments. *Held*, under sec. 6512(b), I.R.C. 1954, the Tax Court has jurisdiction to determine an overpayment of interest as part of its jurisdiction to determine an overpayment of tax on which the interest was paid. *Capital Building & Loan Association v. Commissioner*, 23 B.T.A. 848 (1931), and *Steubenville Bridge Co. v. Commissioner*, 11 T.C. 789 (1948), overruled to the extent that they are inconsistent.

Joe R. Wolfe, for the petitioner.
Keith H. Johnson, for the respondent.

OPINION

GERBER, *Judge*:* Respondent, in a January 9, 1981, statutory notice, determined a deficiency in petitioner's Federal estate tax in the amount of $186,705. The parties now agree that petitioner is entitled to an overpayment, but disagree about the composition and amount of the overpayment. After resolution of other issues by the parties, the following issues[1] remain for our consideration: (1) Whether an overpayment of estate tax, within the meaning of section 6512(b),[2] may include the overpayment of amounts originally paid as tax and interest by means of section 6166A installment payments; and (2) whether respondent properly allocated petitioner's section 6166A installment payments between principal and interest.

The central dispute in this case involves whether interest may be considered a part of an "overpayment" and whether the Tax Court has jurisdiction to review the amount of said interest. With limited exceptions (mostly statutory), this Court has declined to consider questions concerning interest in connection with deficiencies and overpayments. Petitioner has requested that we consider questions of interest in the limited situations where, as here, interest has been overpaid on section 6166A installment payments. Unless there is a clear jurisdictional prohibition or inability, it would be most unjust to require petitioner to seek an overpayment of the tax in this forum and an overpayment of the interest in another. After carefully considering petitioner's and respondent's arguments, we conclude that we possess jurisdiction to determine the amount of interest paid on estate tax installments as part of an overpayment of estate tax.

Facts

The parties have submitted this case fully stipulated and their stipulation of facts and exhibits are incorporated by this reference. Richard B. Baumgardner died on October 16, 1976.

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*By order of the Chief Judge, this case was reassigned from Judge Lapsley W. Hamblen, Jr., to Judge Joel Gerber for disposition.

[1] Petitioner has objected to the relevancy of a transcript of its account from respondent's records. This matter is addressed in the body of this opinion.

[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the year at issue.

A Federal estate tax return was filed with the Atlanta Service Center on January 17, 1978, within an extended filing period granted by the Internal Revenue Service (Service). With its return, the estate filed a notice of its election to pay the estate tax in installments pursuant to section 6166A.[3] The Service sent detailed bills to the estate specifically reflecting the Service's allocations of the required payments into tax (principal) and interest. The estate, without exception or qualification and pursuant to the billings, made the payments to the Service. The following schedule reflects the amount and date of the payments and the Service's allocation between principal and interest:

Date	*Payment*	*Allocation to principal*	*Allocation to interest*
July 20, 1977	$450,000.00	$450,000.00	0
July 17, 1978	107,693.56	69,563.98	$38,129.58
July 13, 1979	100,272.26	69,434.00	30,838.26
July 17, 1980	108,273.13	69,434.00	38,839.13
July 15, 1981	114,446.36	69,434.00	45,012.36
Feb. 12, 1982	305,669.02	305,669.02	0
June 1, 1982	22,008.17	0	22,008.17
Total	1,208,362.50	1,033,535.00	174,827.50

The Federal estate tax return, received by the Service on January 17, 1978, reported $1,033,535 in estate tax. In a January 9, 1981, statutory notice of deficiency, respondent determined a deficiency in Federal estate tax in the amount of $186,705. The estate, by its personal representative (June Baumgardner Gelbart, widow of decedent), filed a timely petition with this Court. At the time of filing the petition, the personal representative's residence and the estate's address were both in the State of Florida. After the case had been petitioned to this Court, the parties settled all of the issues set forth in the notice of deficiency. The settlement resulted in the elimination of the entire amount determined as a deficiency and further reduced the amount of estate tax due to $938,215.07, which amount was $95,319.93 less than the amount originally returned by the estate.

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[3] Although the parties stipulated that petitioner elected installment payments under sec. 6166, petitioner's election was made at a time when only sec. 6166A was available for estates of decedents who died before Jan. 1, 1977. It appears from the record that respondent treated petitioner's election as having been made under sec. 6166A.

Petitioner maintains that the overpayment should be $141,224.63, which takes into account interest overpaid on the section 6166A installments. Respondent maintains that the overpayment should be limited to $95,319.93, the difference between the amount of tax returned ($1,033,535) and the amount of tax the parties agree is due ($938,215.07).

Legal Analysis

"Overpayment" Within the Meaning of Section 6512(b)

Although the parties disagree about the amounts and remedies available, they agree that there is an overpayment of estate tax and interest on that estate tax. Respondent argues that this Court lacks jurisdiction to decide issues concerning interest. His argument suggests that petitioner, if not barred by expiration of the period of limitation on filing a claim, must bring a separate action in a district court or the Claims Court in order to obtain a refund of overpaid interest. Petitioner contends that where the interest is a part of the overpayment, this Court may hold that interest has been overpaid. Where, as here, an estate makes installment payments pursuant to section 6166A and those payments are broken into tax (principal) and interest and paid prior to our determination, an exceptional situation is presented.

Our jurisdiction is limited by statute (section 7442) and is confined to a determination of the amount of a deficiency or overpayment for the particular tax year in which the Commissioner determines a deficiency and in which the taxpayer petitions for a review. *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418, 420 (1943). More specifically, our jurisdiction to determine an overpayment of estate tax is rooted in section 6512(b). The pertinent parts of section 6512(b) provide:

> SEC. 6512(b). OVERPAYMENT DETERMINED BY TAX COURT.—
>
> (1) JURISDICTION TO DETERMINE.—Except as provided by paragraph (2) * * * if the Tax Court finds that there is no deficiency and further finds that the taxpayer has made an overpayment * * * of estate tax in respect of the taxable estate of the same decedent, * * * the Tax Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Tax Court has become final, be credited or refunded to the taxpayer.

> (2) LIMIT ON AMOUNT OF CREDIT OR REFUND.—No such credit or refund shall be allowed or made of any portion of the tax unless the Tax Court determines as part of its decision that such portion was paid—
>
> (A) after the mailing of the notice of deficiency,
>
> (B) within the period which would be applicable under section 6511(b)(2), * * * if on the date of the mailing of the notice of deficiency a claim had been filed (whether or not filed) stating the grounds upon which the Tax Court finds that there is an overpayment, * * *

Section 6512(b) provides that the Tax Court has jurisdiction over "an overpayment * * * of estate tax." The Tax Court has jurisdiction to determine the amount of such overpayment, and such amount shall be credited or refunded to the taxpayer when the decision of the Tax Court becomes final. The Tax Court has jurisdiction to determine an overpayment under section 6512(b)(2)(A) if petitioner pays the amount in question after the mailing of the notice of deficiency. This Court also has jurisdiction to determine an overpayment under section 6512(b)(2)(C) if petitioner has in fact filed a claim for refund of tax paid. Finally, this Court has jurisdiction to determine an overpayment under section 6512(b)(2)(B) if petitioner could have timely filed a claim on the mailing date of the deficiency notice even though petitioner had not in fact filed a claim for refund for tax paid. While the Tax Court has jurisdiction to determine an overpayment, the term "overpayment" is not defined. We must determine whether the use of "estate tax" in section 6512(b) limits our jurisdiction to overpayments of tax alone or whether a broader meaning is intended to permit consideration of overpayments of interest.

The absence of a statutory definition of "overpayment" leads us to search other sources. Section 6401 contains a description of certain specific items that are statutorily treated as overpayments.[4] These classifications do not provide the basis for a definition. The Supreme Court, in deciding whether the refund of an erroneous or illegal assessment was subject to the same statutory period of limitations as other claims for refund of an overpayment, provided the following definition of an "overpayment:" "*any payment in excess of that which is properly due.*" (Emphasis supplied.) *Jones v. Liberty Glass Co.*, 332 U.S. 524, 531 (1947). The *Liberty Glass Co.* generic definition of "overpayment" is in reference to section 322 of the Internal Revenue Code of 1939. Section 322(d) of the Internal Revenue Code of 1939, in pertinent part, included the following language which is substantially similar to its successor, section 6512(b): "If the [Tax Court] finds that there is no deficiency and further finds that the taxpayer has made an overpayment of tax * * *, the [Tax Court] shall have jurisdiction to determine the amount of such overpayment."

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[4] SEC. 6401. AMOUNTS TREATED AS OVERPAYMENTS.

(a) ASSESSMENT AND COLLECTION AFTER LIMITATION PERIOD.—The term "overpayment" includes that part of the amount of the payment of any internal revenue tax which is assessed or collected after expiration of the period of limitation properly applicable thereto.

(b) EXCESSIVE CREDITS.—If the amount allowable as credits under sections 31 (relating to tax withheld on wages), and 39 (relating to certain uses of gasoline, special fuels, and lubricating oils), exceeds the tax imposed by subtitle A (reduced by the credits allowable under subpart A of part IV of subchapter A of chapter 1, other than the credits allowable under sections 31 and 39), the amount of such excess shall be considered an overpayment.

Congress, in providing for interest on underpayments in section 6601(a) also provided in section 6601(e) that "Any reference in this title (except subchapter B of chapter 63, relating to deficiency procedures) to any tax imposed by this title shall be deemed also to refer to interest imposed by this section on such tax." It would appear that the major purpose of the language treating interest and tax the same is to provide the Government with administrative tools to demand payment, assess, and collect the interest in the same manner that has been provided for the tax. Although section 6601(e) reflects the need in appropriate circumstances to avoid unnecessary distinctions between the terms "tax" and "interest," we are not able to find the reference in section 6601(e) directly controlling with respect to section 6512(b). It should be noted that substantially identical language has been used with respect to additions to tax.[5] Accordingly, a restrictive reading of the word "tax" in section 6512(b) would place a limitation upon our overpayment jurisdiction concerning both interest and additions to tax. It should be noted that section 6512(b) is not within subchapter B of chapter 63 of the Internal Revenue Code of 1954 and, accordingly, could be interpreted to be within the ambit of section 6601(e).

When reading section 6512(b), some consideration of its symmetry in conjunction with section 6512(a) is unavoidable.

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[5] SEC. 6662. APPLICABLE RULES.

(2) Any reference to this title to "tax" imposed by this title shall be deemed also to refer to the additions to the tax, additional amounts, and penalties provided by this chapter. * * * [Enacted by Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172.]

Under section 6512(a), a U.S. District Court or the Claims Court has no jurisdiction over a refund suit brought by a taxpayer who has previously petitioned the Tax Court, until such time as the Tax Court's decision is final. This is so even though an overpayment results. See *United States v. Wolf*, 238 F.2d 447 (9th Cir. 1956). Accordingly, there is a clear statutory intent that, in appropriate circumstances, the Tax Court should be able to determine an overpayment to the exclusion of other tax forums. This intent would be frustrated by a reading of sec. 6512(b) that limits the Tax Court's jurisdiction to determining an "overpayment" which varied from "overpayments" that the excluded forums could have found.

In appropriate circumstances, courts may inquire into the legislative purposes even where a statute appears clear on its face. *United States v. American Trucking Associations*, 310 U.S. 534, 543–544 (1940); *J.C. Penney Co. v. Commissioner*, 312 F.2d 65, 68 (2d Cir. 1962), affg. 37 T.C. 1013 (1962); *Carasso v. Commissioner*, 34 T.C. 1139, 1142 (1960), affd. 292 F.2d 367 (2d Cir. 1961). Such inquiry appears particularly appropriate in this case because of the incongruity in the related statutory provisions, established principles concerning overpayments in forums other than the Tax Court, and the acute injustices to petitioner if we do not seek to find harmony in the statutory network.

In the structural sense, the tax code contains provisions for interest on underpayments (deficiencies) and overpayments (refunds). But there are no specific provisions for interest which is a part of an overpayment. The Treasury Department in its interpretation and expansion of the congressional mandate of section 6611 (which provides for interest on overpayments) has treated interest and tax as elements or parts of an "overpayment" upon which interest shall be allowed. Section 301.6611-1(b), Proced. & Admin. Regs., in pertinent part, provides:

> there can be no overpayment of tax until the entire tax liability has been satisfied. Therefore, the dates of overpayment of any tax are the date of payment of the first amount which (when added to the previous payments) is in excess of the tax liability (including any interest, addition to the tax, or additional amount) * * *

In subpart (c) of the same regulation, two examples of assessments, payments, and resulting overpayments are provided. The second example involves a situation where a deficiency had been assessed against a corporate taxpayer and interest had been paid upon the deficiency. In delineating the amounts and dates of overpayments, the regulation states that "The amount of any interest paid with respect to the deficiency * * * is also an overpayment."

As a practical matter, this Court would find it difficult to exercise jurisdiction over interest upon a deficiency. Interest does not accrue upon a deficiency, but only upon the existence of an underpayment. Sec. 6601. In order for a deficiency or tax to be unpaid, the amount must be assessed or assessable. Section 6213 limits the ability of respondent to assess a deficiency until the decision of the Tax Court becomes final. Accordingly, as a practical matter, we would have logistic difficulty exercising jurisdiction over interest on an unpaid and unassessed deficiency.

The statutory framework concerning interest in connection with overpayments is more complex than that concerning underpayments. Generally, jurisdiction concerning overpayments rests with the U.S. District Courts and the U.S. Claims Court. Under limited circumstances, the U.S. Tax Court may acquire overpayment jurisdiction. The Tax Court's overpayment jurisdiction is limited to situations where a deficiency has been determined and the taxpayer petitions this Court for a taxable period. In those situations, the "overpayment" determined by the Tax Court should be synonymous with that determined by a district court or the Claims Court. This is essential because a determination of an overpayment, by any of the three forums, is res judicata. Further complicating this overlapping jurisdiction are the multiple roles that interest may play in relation to an overpayment.

Interest may be part of an overpayment if the interest accrued and was paid prior to the time the overpayment was claimed or arose. This is the type of interest we are considering in this case. Once an overpayment has been determined, either by our Court or one of the "refund forums," interest accrues in accord with section 6611 until the time the overpayment is refunded or reduced to judgment. Once reduced to judgment, interest accrues on the judgment, inclusive of the overpayment (which may include overpaid interest) and interest on the overpayment, all in accord with 28 U.S.C. sec. 2411 (1982). Because our jurisdiction is not derived from Title 28 of the United States Code, we remain unable to enter a decision for interest upon an overpayment. With respect to interest which is part of an overpayment, however, we must be able to determine all components of that overpayment or a taxpayer unwittingly may not be able to recover interest in those situations where the Commissioner initially determined a deficiency and the taxpayer petitioned to the Tax Court. If a taxpayer like petitioner has the option of petitioning the Tax Court, we must assume that Congress intended the Tax Court to have jurisdiction over all components of an overpayment. To assume otherwise would be to presume that a taxpayer could foresee, during deficiency procedures under section 6211 et seq., that he would ultimately end up with an overpayment under section 6512(b) and, prior to the expiration of the statutory limit on the time to file a claim under sec. 6511, bring an action for the amount of interest overpaid. It would be difficult, if not impossible, for one to file a specific enough protective claim under these circumstances.[6] Lack of jurisdiction in this instance would leave taxpayers in a "catch-22" where interest was overpaid and the statute of limitations on claiming the interest had run. Surely Congress did not intend, by section 6512(b) and its predecessors, to expand this Court's jurisdiction to overpayments and, at the same time, create a situation where choice of this forum would provide such unfair results. This is especially so where, as here, there was no way for the taxpayer to predict an overpayment of tax or interest.

We turn now to section 6166A, a relief provision that allows certain estates to pay tax in installments. Petitioner-estate elected, and was permitted by the Service, to utilize the installment payment provisions of section 6166A. The interest upon installments may be deductible under section 2053(a)(2) and, if it is, results in a reduction of the taxable estate and a further need to reduce the amount of future installments under section 6166A. The Service, in Rev. Rul. 80–250, 1980–2 C.B. 278, in explaining when such interest is deductible, would permit a recomputation of the estate tax and previously accrued interest. The ruling, however, notes that no refund will be made until the entire tax liability has been paid. Thus, this ruling implies that the Service would argue that this Court has no jurisdiction over such an "interest payment" but that the Service may administratively adjust and give credit for said amounts to the extent that they are deductible under section 2053(a)(2) without a countervailing ability of the taxpayer to question the Service's actions without paying the full amount of the tax. See also Rev. Rul. 81-294, 1981-2 C.B. 237, and Rev. Proc. 81-27, 1981-2 C.B. 548. Rev. Proc. 81-27 suggests in situations where the interest is deductible, that a supplemental Form 706 be filed but that it "will not be considered a claim for refund or abatement." Accordingly, the "catch-22" problem of no forum to recover interest that precedes an overpayment would continue to exist under respondent's rulings and procedures.

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[6] In situations where deferred payments under sec. 6166 are involved, the possibility that such a claim, if determinable, could be timely made becomes more remote.

This Court has recognized that it cannot ignore issues concerning the interest and principal on deferred payments. In *Estate of Bahr v. Commissioner*, 68 T.C. 74 (1977), we considered the treatment of interest on deferred payments. Although the opinion did not resolve the question of whether interest may be part of an "overpayment" within the meaning of section 6512(b), it did analyze the interest amounts for purposes of their deductibility as administrative expenses of the estate. Continuing in that vein, this Court applied a statutory provision affecting the rate of interest on installment payments made under section 6166 in *Estate of Papson v. Commissioner*, 81 T.C. 105 (1983). In *Estate of Bailly v. Commissioner*, 81 T.C. 246 (1983), we held that an estate that had elected under section 6166 to defer payment of its estate tax liability could not deduct unaccrued interest on that liability as an administrative expense under section 2053(a)(2). Accordingly, in the more recent opinions, this Court has delved into the substantive aspects of "interest issues" where the interest has accrued and/or was paid prior to our determination of a deficiency.

If, in the instant case, we were required to determine which portion of petitioner's section 6166A installment payments constituted tax or principal as opposed to which portion constituted interest, we would, in effect, be within the holdings of our more recent opinions and would also determine that some portion of a potential overpayment is or is not interest. In a supplemental opinion to *Estate of Bailly v. Commissioner*, 81 T.C. 949 (1983) (originally decided at 81 T.C. 246), we postponed entry of our earlier decision because of concern that section 6512(a) would bar a subsequent action by the taxpayer to obtain an estate tax deduction for interest accruing on tax liabilities.

In essence, we have already exercised jurisdiction over questions of interest, for if we were to find that respondent had incorrectly allocated too much of a section 6166A installment payment to interest, we could hold that the amount of interest deducted was too large. In so holding, we would be increasing the amount of "tax" overpaid. The theory which would permit our determination of the amount of interest in this setting is one which recognizes that it is essential to be able to consider all payments made until the time of the actual overpayment. To interpret the statute otherwise would specifically limit our ability to determine an overpayment and frustrate our congressionally conferred jurisdiction. The facts in this case present a situation where respondent agrees that petitioner-estate has no deficiency and, further, has reported too much tax on its estate tax return. In such a circumstance, "interest" payments made by the estate on the installments of estate tax which were finally determined not to be due, were not actually interest payments. Stated more directly, payments made before this Court's determination of a deficiency or overpayment cannot be considered to constitute tax or interest to the exclusion of this Court's jurisdiction.

Development of the Case Law

Respondent, without reference to the statutes, maintains that case law supports the argument that the Tax Court lacks jurisdiction over interest. Respondent's understanding of the case law is correct. The case law, however, developed more than 50 years ago and resolved the question by the expedient of restricting our jurisdiction short of the statutory grant.

The most complete presentation of the rationale for finding no jurisdiction where there was overpaid interest is found in *Capital Building & Loan Association v. Commissioner*, 23 B.T.A. 848 (1931), supplemental opinion 23 B.T.A. 1117 (1931), revd. on another issue 63 F.2d 462 (D.C. Cir. 1933). In that case, deficiencies were initially determined for the taxpayer's 1924 and 1926 tax years. The parties later stipulated that there were no deficiencies for those years and that the taxpayer had actually overpaid its taxes. The taxpayer requested the Board to determine overpayments of tax and interest, which had been assessed and paid on the deficiency amounts. The Board stated that the controversy before it related "to the question as to whether the Board has jurisdiction to determine whether the amount of interest paid on a conceded overpayment of taxes is an overpayment." *Capital Building & Loan Association v. Commissioner, supra* at 849. The Board referred to section 284(e) of the Revenue Act of 1926, 44 Stat. 9, which is a predecessor to section 6512(b), and found that the overpayment referred to in the statute was "an overpayment of *tax*." (Emphasis in the original.) Reasoning that "The interest on the tax is not tax but is something in addition to the tax," the Board concluded that "The additions to the tax or additional amounts added to the tax are not the tax which is referred to in the statute which we can find has been overpaid." *Capital Building & Loan Association v. Commissioner, supra* at 849. Also see *Steubenville Bridge Co. v. Commissioner*, 11 T.C. 789 (1948) (the Tax Court, in finding an overpayment of tax, declared that it lacked jurisdiction to find an overpayment of interest where taxpayer had paid tax and interest on a deficiency barred by the statute of limitations). The 1926 Revenue Act was phrased similarly to section 6512(b). There was no compulsion to so restrictively read this language. This Court could have read the phrase "overpayment of tax" as part of the threshold necessary to be able to further enable the Tax Court "to determine the amount of such overpayment." There was no compelling reason to interpret the word "tax" to exclude additions to the tax or interest. There was, instead, reason to consider interest as part of an overpayment.

Prior opinions on this issue have focused on the Tax Court's role in providing a prepayment forum for taxpayers. They myopically see this purpose along with the statutorily limited jurisdiction as reasons to be extra conservative in determining the Tax Court's jurisdiction. But these opinions have failed to recognize that Congress has legislatively provided for the exceptional situation where, after a deficiency has been determined and the taxpayer has petitioned the Tax Court, an overpayment results. Although there is no legislative history to assist us, it is hard to imagine that Congress could have intended to bifurcate an "overpayment" by limiting the taxpayer's refund to "tax" only. It is equally hard to imagine that an "overpayment" has a different meaning depending upon the forum. Either of those approaches would force some taxpayers to resolve a single tax controversy in two different forums. Strangely, those forced to unreasonably duplicate their costs and efforts would be the lucky ones because, as in this case, others would be barred from recovery of the interest portion of the overpayment due to their failure and/or inability to make a timely claim.

In *Commissioner v. Estate of Kilpatrick*, 140 F.2d 887 (6th Cir. 1944), affg. a Memorandum Opinion of this Court, a deficiency was determined in the estate's income tax liability for 1937. Kilpatrick's executor filed a petition with the Board of Tax Appeals to redetermine the deficiency. To prevent the accumulation of interest upon the deficiency, the taxpayer paid the amount of tax ($39,364.13) together with interest ($7,660.37).[7] The Board ignored the interest item in determining that there had been an overpayment of $39,364.13.

The Sixth Circuit pointed out that no portion or aspect of a deficiency determination by the Commissioner is assessable or fixed until this Court's decision becomes final. Accordingly, they treated the payment of interest as a "gratuitous" act on behalf of the taxpayer. Where, however, there is no deficiency to be found, we are left to sort out which of the payments, made prior to our decision, may have been overpaid. *Commissioner v. Estate of Kilpatrick, supra*, is distinguishable on the basis that it addresses an unassessed deposit, unlike the instant case which involves payment of assessed tax and interest.

In essence, the payments which the parties agree are overpaid merge to become the amount refundable known as the "overpayment." The use of the word "tax" in section 6512(b) could be equated with the word "principal." This synonymous relationship is clearly illustrated where the estate tax liability is submitted by means of installment payments under section 6166A. Whether this Court redetermines which of those payments are interest or principal (tax), or the parties agree they are overpaid, they merge and become "principal" or "tax," for the original designation of those payments by the parties was not final, and this Court could have redetermined their character for purposes of a deduction or overpayment. See *Estate of Bahr v. Commissioner*, 68 T.C. 74 (1977), where interest on installment payments was analyzed for purposes of deductibility.

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[7] It should be noted that the Internal Revenue Code prior to 1954 provided for interest upon interest. Recent amendments in TEFRA, Pub. L. 97-248, 96 Stat. 324, have again provided for compounded interest. This may increase the frequency with which this issue may arise because of taxpayers' concern about extra costs during the delay of litigation. Further, Congress has added situations where we may be required to decide whether increased interest may apply. Sec. 6621(d).

The unnecessarily restrictive approach of *Capital Building & Loan Association v. Commissioner, supra*, has not been meaningfully revisited for more than 40 years. Since that time, many factors have evolved which, in retrospect, do not reflect well upon the original approach. Moreover, other courts have readily included and treated interest as a part of an overpayment where the interest was paid prior to the event of overpayment.

In *Alexander Proudfoot Co. v. United States*, 197 Ct. Cl. 219, 454 F.2d 1379 (1972), the U.S. Court of Claims stated that deficiency interest assessed and collected (paid) assimilates into the tax. The Government argued, and the court agreed, that this pre-notice interest is a part of an overpayment and should be sought in a claim for refund. The court stated that—

> The Code's design for such interest is to assimilate it to the tax itself so that the taxpayer who pays both * * * can and should proceed to seek to recover both together through one proceeding. For a long time, deficiency interest has been so closely braided to principal that it has been deemed an integral part of the tax. That is plainly a major purpose of § 6601(f)(1) * * * which follows many predecessors with the same aim. The hair is to go with the hide. [*Alexander Proudfoot Co. v. United States, supra* at 1382.]

Considering the overcrowded dockets in most Federal courts, we cannot be insensitive to opportunities to avoid unnecessary litigation. It appears that it is now appropriate to retrace our steps and retract our overly conservative position by reversing prior precedent, to the extent that those opinions preclude this Court from finding payments of interest as part of an "overpayment."[8] Thus, we conclude that we have jurisdiction to consider interest as a part of an overpayment in this case and to that limited extent, *Capital Building & Loan Association v. Commissioner, supra*, and *Steubenville Bridge Co. v. Commissioner, supra*, are overruled.

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[8] In analogous situations concerning statutes enacted after the predecessor of sec. 6512 there

Allocation of Payment and Evidentiary Issue

Petitioner questions respondent's allocation of installment payments between tax and interest. As part of this issue, petitioner has objected to the materiality and relevancy of a transcript of petitioner-estate's tax account, as maintained by respondent. The Transcript of Account was stipulated to by the parties as Exhibit 2-B and the document is a transcript of a business record maintained by respondent. The transcript merely reflects the transactions that occurred regarding petitioner-estate's tax account with respondent. The transcript is relevant and material to the extent that it reflects respondent's record of various events and transactions and, accordingly, petitioner's objection is overruled. Respondent's record of these transactions merely reflects entries characterized by respondent. Such records are not dispositive of the issues before this Court.

Respondent has not addressed the method of determining the amount of "pre-notice" interest (interest assessed and collected at the time of the overpayment), since it was respondent's position that this Court lacked jurisdiction to consider any questions of interest in connection with an overpayment. Petitioner seeks to have us ignore the original allocation of installment payments into tax and interest. We, however, are unable to determine that respondent's original allocations were improper.

If a taxpayer makes a voluntary payment without directing application of funds, the Service may make whatever allocation it chooses. *Muntwyler v. United States*, 703 F.2d 1030,

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have been specific provisions for interest and additions to tax. Sec. 6861(c). The situations are ones where the tax and interest must necessarily be assessed and/or collected prior to our consideration of the case. Conceptually, the jeopardy assessment situation is the same as overpayments including tax and interest because the payment occurs before we are able to render an opinion. In the jeopardy assessment situations, there is no hesitancy in dealing with interest questions and no logistic problems since, as here, the payments occur prior to the determination of a deficiency or overpayment. *Papa v. Commissioner*, 55 T.C. 1140 (1971); *Riss & Co. v. Commissioner*, 45 T.C. 230 (1965). Transferee cases, similarily, require the determination of the amount, rate, and starting date of interest on transfers. *Estate of Stein v. Commissioner*, 37 T.C. 945, 959–960 (1962). These instances should dispel any question about this Court's ability to enter a decision concerning interest in connection with tax.

1032 (7th Cir. 1983). In *Amos v. Commissioner*, 47 T.C. 65, 69 (1966), this Court defined an involuntary payment of taxes as "any payment received by agents of the United States as a result of distraint or levy or from a legal proceeding in which the Government is seeking to collect its delinquent taxes or file a claim therefor." Since the circumstances described in *Amos* are absent here, we find that the installment payments made by petitioner were voluntary. Nothing in the record before us indicates that petitioner ever directed application of the payments between principal and interest; on the contrary, the record reflects that the estate accepted the allocations made by respondent. Petitioner received bills from the Service for the installment payments that apprised it of the allocations between tax and interest proposed by respondent. Thus, we conclude that respondent properly allocated the original payments as between principal and interest.

Amount of the Overpayment

Our holding that the term "overpayment" includes assessed and paid interest at the time of overpayment and that respondent's original allocations are proper would normally leave the parties with the responsibility of calculating the correct amount of the overpayment under Rule 155 of this Court's Rules of Practice and Procedure.

Interest upon an overpayment begins to run "from the date of the overpayment." Sec. 6611. Until the time of the overpayment, any tax, interest, or additions to tax, paid in accordance with an assessment, is a part of the "overpayment." Generally, an "overpayment," as a word of art, requires payment with a return or in response to an assessment. *Rosenman v. United States*, 323 U.S. 658 (1945). Although *Rosenman* continues to have vitality, it has not been woodenly applied. *Rosenman* has been distinguished in situations where a taxpayer makes payments based upon a bona fide estimate of an uncollected tax liability. *Charles Leich & Co. v. United States*, 165 Ct. Cl. 127, 329 F.2d 649 (1964); *Northern Natural Gas Co. v. United States*, 173 Ct. Cl. 881, 354 F.2d 310 (1965). The facts in this case come within *Rosenman* because petitioner paid the $1,208,362.50 pursuant to the amount returned by the estate.

Naturally, an overpayment occurs when "any payment [is] in excess of that which is properly due." *Jones v. Liberty Glass*

Co., 332 U.S. 524, 531 (1947). The tax must be paid in full as the prerequisite to the commencement of a refund suit. *Flora v. United States*, 357 U.S. 63 (1958). Payment of assessed interest, however, is not a prerequisite to commencement of a refund suit. *Flora v. United States*, 362 U.S. 145 (1960); *Kell-Strom Tool Co. v. United States*, 205 F. Supp. 190 (D. Conn. 1962). As to the tax payable in installments, if a taxpayer has "overpaid" an installment, the "overpayment" would be credited to any unpaid installments. Sec. 6402. An overpayment of an installment is not an "overpayment of tax" until the entire amount of the tax has been paid. *Blair v. Birkenstock*, 271 U.S. 348 (1926); *Flora v. United States*, 357 U.S. 63 (1963).

The parties in this case have agreed that the correct estate tax liability should have been $938,215.07. Under any theory of allocation of payments between tax and interest, the overpayment of tax must have occurred on February 12, 1982. Normally, the parties would compute the unpaid portions of the correct tax liability when each installment is made. In this manner, the correct amount of an overpayment, which includes assessed and collected tax and interest, can be reconstructed. Due to the agreed reduction in the amount of estate tax due, the amount of interest due with each installment would have been reduced and, accordingly, the amount of each payment attributable to the tax (principal) would have increased, further reducing the interest and increasing the principal in subsequent payments. See sec. 20.6166A-1(f), Estate Tax Regs. To the extent of these determinations, the amounts of overpaid estate tax would have increased and this Court would have exercised no more jurisdiction than we have in other similar situations. See *Estate of Papson v. Commissioner*, 81 T.C. 105 (1983).

Petitioner has submitted and respondent has stipulated to a computation of the amount of an overpayment inclusive of assessed and collected tax and interest thereby obviating the need for a computation under Rule 155. Petitioner's computation of the $141,224.63 overpayment is based upon the facts agreed to by the parties.

Further, the parties have effectively anticipated the circuitous nature of the computation occasioned by the deduction of interest on estate tax where the tax is paid in installments by agreeing to deductibility of interest on the estate's Form 1041 after a time certain in 1980, rather than factoring such amounts into the reduction of estate tax installment payments. The payment requirements and time limits specified in sections 6511 and 6512 have been met. The dates of payment for purposes of any subsequent interest computations once our opinion becomes final have been stipulated by the parties and are set forth as findings in this opinion.

Decision will be entered for the petitioner.

Reviewed by the Court.

STERRETT, SIMPSON, GOFFE, WILBUR, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, and WRIGHT, *JJ.*, agree with this opinion.

JACOBS, *J.*, did not participate in the consideration of this case.

EDWARD BARONE, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 19258–84. Filed September 17, 1985.

Petitioner was an owner-operator who drove tractor trailers in interstate commerce for a single carrier. When he was not on the road, he resided at his parent's house. Petitioner deducted travel expenses, sheets and a mattress purchased for use in his truck, and tennis shoes. *Held*: Petitioner did not have a "tax home" and is, therefore, not entitled to deduct any travel expenses, nor is he entitled to deduct the cost of tennis shoes. Petitioner may deduct the sheets and mattress expenses under sec. 162, I.R.C. 1954.

Petitioner also deducted two types of fines: those paid by him for violations with which he was personally charged while operating his truck, and amounts withheld from his pay in order to reimburse the carrier for a penalty imposed upon it. *Held*: Personal fines are nondeductible under sec. 162(f), I.R.C. 1954. Amounts involuntarily paid by him for penalties imposed upon the carrier are deductible under sec. 162(a), I.R.C. 1954; sec. 162(f), I.R.C. 1954, does not prohibit the deduction.

Edward Barone, pro se.

Anne W. Durning, for the respondent.

GOFFE, *Judge*: The Commissioner determined a deficiency in petitioner's Federal income tax for the taxable year 1981 in the amount of $529.

Petitioner Edward Barone timely filed his Federal income tax return for the taxable year 1981 with the Internal Revenue Service Center in Ogden, Utah. Petitioner resided in Mesa, Arizona, at the time the petition was filed in this case.

After concessions by the parties, the only issues left for decision are: (1) Whether petitioner maintained a "tax home" during the taxable year 1981 and is, therefore, entitled to claimed travel expense deductions under section 162;[1] (2) whether petitioner may deduct fines resulting from violations with which he was charged while operating his truck; (3) whether petitioner may deduct an amount withheld from his paycheck in order to pay a fine resulting from a violation with which he was not charged; (4) whether petitioner is entitled to a claimed deduction for a mattress and sheets he bought for his truck; and (5) whether petitioner may deduct the cost of tennis shoes he wore while driving his truck.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated by this reference.

Petitioner was the owner-operator of a Peterbilt tractor and was engaged exclusively in pulling tractor trailers in interstate driving for Interstate Contract Carrier Corp. (ICCC) with a home terminal located in Phoenix, Arizona, during the taxable year in issue.

When petitioner was on the road, he either stayed in a motel or slept in the sleeping compartment of the cab. When petitioner was between trips or in the Phoenix area, he stayed at his parent's residence in Mesa, Arizona.

During the taxable year 1981, petitioner had eight trips which originated or terminated in the vicinity of Phoenix, Arizona, and was on the road for 227 days and at his parents' residence for 138 days.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended, and all Rule references are to the Tax Court Rules of Practice and Procedure.

While staying at his parents' house, petitioner had the use of his own bedroom, bathroom, and telephone. In addition to paying his share of the electric and phone bills, he paid his mother $1 per day when he was on the road and $2 per day when he was actually at the Mesa residence, e.g., if he was at his parents' home for 15 out of 30 days, petitioner paid his mother $45.

On June 11, 1981, following an inspection of the truck Mr. Barone was driving, the Virginia State Corporation Commission charged ICCC with a violation of rule 5 of the Virginia State Corporation Commission's Rules and Regulations Governing the Operation of Motor Vehicles Under Lease (1973).[2] The violation resulted from an inadequate lease that ICCC had given petitioner. Rather than contest the charge, ICCC paid the $200 fine. ICCC then withheld $200 from petitioner's paycheck without his consent.

Of the items disallowed by the Commissioner and still in issue, petitioner claimed the following deductions on his Federal income tax return for the taxable year 1981: travel expenses of $380 for lodging, $4,380 for food, and $90 for laundry. Under the heading "clothing expenses" petitioner claimed as a deduction the following: a pair of $20 Nike tennis shoes that he wore while driving, $97 for a mattress and sheets for the cab of his tractor, and $296 for showers he took while traveling on the road.

Petitioner also claimed a deduction for "violations" in the aggregate amount of $578. Of this amount, $378 represents fines petitioner paid for violations with which he was charged while operating his truck. The remaining $200 represents the amount ICCC withheld from petitioner's paycheck in order to pay ICCC's rule 5 violation penalty.

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[2] RULE 5

No road tractor, tractor truck, truck, or passenger carrying vehicle having more than 2 axles shall be operated in interstate commerce to, through, or from Virginia under lease or sublease unless there is on board such vehicle a copy of the lease and sublease. Such lease and sublease shall either be in accord with the provisions of the form required by the State Corporation Commission or in accord with the regulations of the Interstate Commerce Commission. A motor vehicle may be operated upon Virginia highways with a State Corporation Commission registration card in lieu of such lease or sublease provided that the parties to the lease are properly identified on the registration card.

OPINION

The first issue for decision is whether petitioner maintained a "tax home" during the taxable year in issue entitling him to deductions for travel expenses under section 162.

Section 162(a)(2) allows a deduction for "traveling expenses * * * while away from home in the pursuit of a trade or business." To qualify for this deduction, three conditions must be met: (1) The expenses must be ordinary and necessary; (2) the expenses must have been incurred while petitioner was "away from home;" and (3) petitioner must have incurred the expenses in pursuit of a trade or business. *Commissioner v. Flowers*, 326 U.S. 465 (1946), rehearing denied 326 U.S. 812 (1946); *Cockrell v. Commissioner*, 321 F.2d 504, 507 (8th Cir. 1963), affg. 38 T.C. 470 (1962). Respondent does not argue that petitioner has failed to satisfy the first and third tests of *Flowers*. The issue is whether petitioner was "away from home" when he incurred the expenses.

It is somewhat tautological to state that in order to be "away from home," one must have a "home" to be "away from." As a general rule, a taxpayer's principal place of business is his "tax home." *Kroll v. Commissioner*, 49 T.C. 557, 562 (1968). An employee without a principal place of business may treat a permanent place of residence at which he incurs substantial continuing living expenses as his tax home. *Sapson v. Commissioner*, 49 T.C. 636, 640 (1968). However, where the taxpayer has neither a principal place of business nor a permanent residence, he has no tax home from which he can be away. His home is wherever he happens to be. *Brandl v. Commissioner*, 513 F.2d 697, 699 (6th Cir. 1975), affg. a Memorandum Opinion of this Court; *Rosenspan v. United States*, 438 F.2d 905, 912 (2d Cir. 1971), cert. denied 404 U.S. 864 (1971); *James v. United States*, 308 F.2d 204 (9th Cir. 1962).

While the subjective intent of the taxpayer is to be considered in determining whether he has a tax home, for purposes of section 162(a)(2), this Court and others consistently have held that objective financial criteria bear a closer relationship to the underlying purpose of the deduction. The section is intended to mitigate the burden of a taxpayer who, because of the travel requirements of his trade or business, must maintain two places of abode and therefore incur additional living expenses. *Brandl v. Commissioner, supra; Kroll v. Commission-*

er, supra. Section 162(a)(2) provides some relief for a taxpayer who incurs "substantial continuing expenses" of a home which are duplicated by business travel away from home on a temporary basis, by allowing a deduction for the expenses of such travel. *James v. United States, supra* at 207.

Whether petitioner had a tax home is a factual question, and the burden of proof is on petitioner. *Welch v. Helvering*, 290 U.S. 111 (1933); *Rambo v. Commissioner*, 69 T.C. 920 (1978); Rule 142(a).

At trial, petitioner advanced two arguments concerning the existence of a tax home. First, he argues that Phoenix was his "principal place of business" and second, he argues that he incurred substantial continuing expenses in the maintenance of a home which were duplicated by his business travel expenses.

In his attempt to show that Phoenix was his principal place of business, petitioner points out that his home terminal was in Phoenix and that eight trips either terminated or originated in the Phoenix area. These facts alone do not require a finding that Phoenix was his principal place of business. The relatively few business connections petitioner had with the Phoenix area are indicative that petitioner's true place of business was on the road.

Petitioner's second argument that his claimed travel expenses duplicated the expenses he incurred while at his alleged "tax home" is similarly unsupported by the facts. Petitioner's total payment to his parents for the use of a bedroom and bathroom in their house amounts to $503 for the taxable year 1981.[3] This token amount together with payments he made for his share of the electric and telephone bills does not constitute substantial, continuing living expenses. *Sapson v. Commissioner, supra*.

Thus, petitioner has failed to demonstrate that he had a "tax home" during the taxable year 1981 and he is not entitled to any of the travel deductions he claimed under section 162.[4]

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[3] This amount is computed as follows:

Location	*Number of days*		*Rate*		
At parents' house	138	×	$2	=	$276
On the road	227	×	1	=	227
Total					503

[4] Included in the amount disallowed for petitioner's travel expenses is the $296 spent for showers. Although claimed as a "clothing expense," this item is more properly characterized as a travel expense.

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The second issue is whether petitioner may deduct the $378 he paid in fines resulting from violations with which he was charged while operating his truck. The Internal Revenue Code explicitly states that these payments are nondeductible expenses under section 162(f).[5]

The next issue for decision is whether petitioner may deduct an amount withheld from his paycheck in order to pay a fine resulting from a violation with which he was not charged as a trade or business expense under section 162(a). Respondent argues that, as a matter of public policy, because Mr. Barone was the driver of the truck during the inspection, he is somehow responsible for the inadequacy of the lease that resulted in ICCC's being charged with the rule 5 violation, thus making the amount ICCC withheld from him a nondeductible expense under section 162(f).

We disagree with this argument because section 162(f) only applies to "any fine or similar penalty paid to a government." In this case, petitioner did not make any payment of this sort. While the $200 withheld represented payment for a fine, it was for a violation with which ICCC was charged, not Mr. Barone.

Although there are numerous cases where courts have investigated the language of section 162(f), none has involved a situation where a taxpayer seeks to deduct a penalty with which another person was charged. See, e.g., *Mason & Dixon Lines, Inc. v. United States*, 708 F.2d 1043, 1046 (6th Cir. 1983); *Huff v. Commissioner*, 80 T.C. 804, 820–824 (1983); *Southern Pacific Transportation Co. v. Commissioner*, 75 T.C. 497, 646–652 (1980); *S & B Restaurant, Inc. v. Commissioner*, 73 T.C. 1226, 1230–1234 (1980); *Middle Atlantic Distributors, Inc. v. Commissioner*, 72 T.C. 1136, 1140–1146 (1979).

We decline to extend the term "fine or penalty" so broadly as to include the amount withheld. Nowhere in the regulations is there language to support respondent's construction of section 162(f). Section 1.162–21, Income Tax Regs., provides:

> Sec. 1.162–21. Fines and penalties.
>
> (a) *In general.* No deduction shall be allowed under section 162(a) for any fine or similar penalty paid to—

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[5] SEC. 162(f). FINES AND PENALTIES.—No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law.

> (1) The government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;
>
> (2) The government of a foreign country; or
>
> (3) A political subdivision of, or corporation or other entity serving as an agency or instrumentality of, any of the above.
>
> (b) *Definition*. (1) For purposes of this section a fine or similar penalty includes an amount—
>
> (i) Paid pursuant to conviction or a plea of guilty or *nolo contendere* for a crime (felony or misdemeanor) in a criminal proceeding;
>
> (ii) Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Internal Revenue Code of 1954;
>
> (iii) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or
>
> (iv) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.
>
> (2) The amount of a fine or penalty does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty, nor court costs assessed against the taxpayer, or stenographic and printing charges. Compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

Therefore, we hold that the language of section 162(f) does not render nondeductible the payments of the sort petitioner made to ICCC through withholding from his pay. The deduction is allowed.[6]

The fourth issue for decision is whether petitioner is entitled to a deduction under section 162 in the amount of $97 for a mattress and sheets. The Commissioner disallowed this expense because it was not established that it was for an ordinary and necessary business expense. At trial and on brief, respondent argued for disallowance on the alternative basis that the purchased items were capital investments recoverable only through depreciation. We refuse to consider this ground for disallowance as the argument was not timely made. *Seligman v. Commissioner*, 84 T.C. 191, 197–199 (1985).

The Commissioner's determination to disallow the deduction of this expense under section 162(a) is presumptively correct and petitioner bears the burden of proving he is entitled to the deductions claimed. Rule 142(a). At trial, the petitioner testified that he bought the mattress and sheets for use in his truck. We are satisfied that these items constitute ordinary and necessary business expenses deductible under section 162, and hold for petitioner on this issue.

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[6] The respondent challenged this deduction only on the grounds that it contravenes sec. 162(f). Having held that this deduction is not invalid under sec. 162(f), we need not investigate this deduction further. *S & B Restaurant, Inc. v. Commissioner*, 73 T.C. 1226, 1230 (1980).

The last issue is whether petitioner may deduct under section 162(a) the cost of the Nike tennis shoes he wore while driving his truck. Petitioner testified that lightweight shoes were essential when driving for long periods of time and that he wore this pair only while driving his truck.

The general rule concerning the deductibility of work clothes under section 162(a) is that they must be of a type specifically required as a condition of employment and not adaptable to general usage as ordinary clothing. *Donnelly v. Commissioner*, 262 F.2d 411, 412 (2d Cir. 1959), affg. 28 T.C. 1278 (1957).

The tennis shoes petitioner purchased do not fall within this rule and we deny the claimed deduction. The tennis shoes, while used exclusively for work, were not specifically required as a condition of employment and could be used generally as ordinary clothing.

To reflect the foregoing,

Decision will be entered under Rule 155.

FREDERICK C. JOHNSON AND JUDITH A. JOHNSON, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 26253–83. Filed September 17, 1985.

P's purchased a substantial number of Indian artifacts and etchings. After holding them for the required capital gain period, P's donated substantially all the artifacts and about two-fifths of the etchings to a qualified charitable organization. A pattern of abuse designed to achieve excessive valuations of the donated items was evident. The donated items were grossly overvalued. *Held*, respondent's valuation of the donated items reflects fair market value as of the dates of donation. *Held, further*, we find, sua sponte, an addition to interest under sec.

6621(d), I.R.C. 1954, to be appropriate due to substantial underpayments attributable to tax motivated transactions.

Arthur H. Boetler, for the petitioners.
Wayne Appleman, for the respondent.

HAMBLEN, *Judge*: Respondent determined the following deficiencies in petitioners' Federal income taxes:

Year	*Deficiency*
1976	$8,195
1977	17,217
1978	152

The issues in this case are the fair market value of certain Indian artifacts[1] and etchings donated to the Museum of Native American Cultures (MONAC)[2] and the application of section 6621(d)[3] as to interest on substantial underpayments attributable to tax motivated transactions.

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners resided in Bellevue, Washington, when they filed their petition in this case.

Petitioner Frederick Johnson (Frederick) was a contractor. Petitioner Judith Johnson (Judy) was a homemaker and part-time purveyor of art and antiques.

Petitioners began to collect art and antiques in 1970, and Judy took art history courses during 1976. During the years in issue, however, petitioners' level of art sophistication approximated only that of hobbyists.

Petitioners became friendly with Patsy Converse Bates (Bates) in March of 1976. Bates operated the Converse Galleries, where she performed as a dealer and appraiser of art and antiques.

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[1] The petitioners purchased a collection of 143 baskets and 2 model canoes. They donated 130 baskets and 2 model canoes. We refer hereinafter to the above in the aggregate as artifacts.

[2] The Museum of Native American Cultures is also known as the Pacific Northwest Indian Center, Inc.

[3] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

Bates introduced petitioners to Wilfred Schoenberg (Schoenberg) in May of 1976. Schoenberg had founded MONAC in December of 1965. During the years 1976 and 1977, he served MONAC as president, chairman, and curator. Schoenberg was intimately involved in the encouragement of donations to MONAC.

MONAC published a brochure to inform potential investors of a special service which it provided. MONAC represented in the brochure that it could locate special bargains of Indian art objects for potential donors. Upon request, MONAC would arrange to deliver the purchased items to potential donors or provide storage for the appropriate capital gain holding period. Additionally, MONAC unilaterally would provide at least two appraisals of the art objects as well as other necessary documentation related to substantiation for tax purposes. MONAC maintained a list of 10 to 12 experts who would provide appraisals of such donated items at no cost. These experts often were "friends" or "associates" of MONAC.

In June of 1976, and following the procedures outlined in the MONAC brochure, Schoenberg located certain artifacts in the gallery of Paul Masa (Masa), an experienced dealer of Indian artifacts. Masa had paid $9,000 for the artifacts less than 1 year prior to his sale of the artifacts to petitioners. Petitioners purchased the artifacts on June 28, 1976. In arranging the transaction, petitioners never discussed their purchase with Masa. Schoenberg delivered the artifacts to petitioners for inspection. Upon inspection, petitioners paid Masa $12,000 for the artifacts by personal check.

Prior to petitioners' purchase of the artifacts, Schoenberg prepared two valuation lists of the artifacts. One list contained 145 artifacts valued at $40,385. The other list contained 144 artifacts valued at $48,805. Schoenberg offered no explanation as to the divergent valuations. Petitioners received the lists from Schoenberg about the time he delivered the artifacts to them for inspection. According to Schoenberg, he had prepared both lists to serve as estimates for insurance purposes. However, there is no indication in the record that petitioners ever insured the artifacts.

Petitioners donated 132 artifacts to MONAC in December of 1976. As outlined in the brochure, MONAC secured two appraisals of the donation as follows:

Appraiser	*Appraisal*	*Date*
Tom Fitzgerald (Fitzgerald)	$50,705	1/25/77
Bates	63,845	1/22/77

Petitioners adopted the Bates appraisal and valued the contribution at $63,845 on their 1976 tax return.

Petitioners purchased 500 etchings by Ace Powell from Masa in February of 1977. They paid Masa $5,000 for the etchings. The basis of Masa in these etchings was approximately $3,700. Schoenberg was not an agent in the transaction.

In March of 1977, Judy began employment with Bates at Converse Galleries. Judy's job was to sell art and antiques. In her employee capacity, Judy drafted a letter to a potential investor which detailed items available for a "tax write-off" and represented that the items "should appraise out" at specific values which averaged in excess of 4 times investor cost. Judy left this employment in January of 1978 because she questioned the moral values of Bates. In November of 1981, Bates was found guilty of attempted theft in the first degree concerning a fraudulent insurance claim. The matter of the Bates conviction was not related in any manner to petitioners.

Petitioners donated 194 of the Powell etchings to MONAC in February of 1977. They claimed a deduction for the contribution of the etchings in an amount of $13,975 on their 1977 Federal income tax return. MONAC had provided two appraisals of the Powell etchings. In February of 1978, petitioners had Bates prepare a third appraisal. Bates appraised the etchings in an amount of $13,975, which was in excess of both appraisals furnished by MONAC and which petitioners deducted on their 1977 tax return. Petitioners used the Bates appraisal as the basis of this contribution deduction on their 1977 tax return, notwithstanding that Judy had left the employment of Bates in January of 1978 because she questioned Bates' moral character.

In the notice of deficiency, respondent determined that the fair market values of the donated items were:

Artifacts	$19,618
Etchings	5,000

Expert Valuations

Michael Johnson

One of petitioners' experts is Michael Johnson (Johnson), who operated an art gallery in Seattle, Washington, for a period of 12 years. The gallery emphasized American Indian art. Johnson closed the gallery in 1980. However, he actively continued in business as a private dealer and appraiser of American Indian art.

Johnson stated that Indian art prices soared during the mid-1970's, in general, and during 1976, in particular. He estimated the average annual appreciation rate to be 20 percent during that period.

Johnson valued the artifacts collection at $35,150. Johnson concluded that the artifacts were, in general, of average to slightly below average quality. He did not view the artifact collection. His valuation was based on photographs and descriptions supplied by petitioners. He indicated that the photographs were not particularly helpful due to poor photocopying quality. Therefore, he relied primarily on the descriptions. Johnson did not value each artifact on an individual basis. Instead he grouped the artifacts according to tribal association. Sotheby Parke Bernet (Sotheby) catalogs for the years 1979, 1980, 1981, and 1982 were used to determine a price range for each tribal group. Johnson then multiplied the number of artifacts in each tribal group by a single price within the range which he determined to be representative of the entire group.

Walter Crawford

Another of petitioners' experts is Walter Crawford (Crawford), who has had extensive experience concerning American Indian items due to varied involvement since 1926. His primary experience has been that of a dealer of Indian items, including pottery, textiles, and jewelry. Additionally, he has been an appraiser of such Indian items for 30 years.

Crawford did not view any of the items in issue. He determined a valuation based on the photographs and descriptions supplied by petitioners. At trial, he was not sure whether the descriptions were provided by petitioners. Although Crawford was aided by an assistant in the preparation of his report, the assistant did not sign the report or testify at trial.

Crawford indicated that an appraisal was not possible for 41 artifacts because petitioners had supplied unclear photocopied photographs. In these instances, he provided an estimated value rather than an appraised value.

Crawford valued the artifact collection at $48,420. He valued each item on an individual basis. He researched public auction catalogs and sales records of other dealers of similar items. Crawford attached to his report three catalogs from public auctions held in years 1979, 1980, and 1981.

Crawford has, in the past, performed several appraisals for MONAC at no expense. He first met Schoenberg in 1974, at which time he donated a collection of items of the Northwest to MONAC. Crawford has remained a frequent benefactor of MONAC.

Richard Cleland

Respondent's expert, Richard Cleland (Cleland), owned an art gallery in Scottsdale, Arizona. He had been in the business for 13 years. His gallery was of primary interest to collectors, and featured Indian baskets and Indian textiles, as well as Spanish colonial furniture.

Cleland concluded that the artifacts were of average to poor quality, of the type sold to tourists. He indicated that the artifacts, as a group, did not exhibit the depth and breath of style, design, or total origin necessary to enhance them as a study collection.

Cleland traveled to MONAC to view the artifact collection. He was able, however, to view only 19 of the 132 donated artifacts as MONAC typically sold donated items to generate funds. Cleland was not surprised by the absence of the artifacts. MONAC did not maintain business records of the sales.

Cleland appraised the 19 artifacts which he viewed at MONAC. He referred to public auction catalogs, including Sotheby's, as well as sales of his own gallery and other dealers.

With reservations, Cleland found the descriptions adequate to provide an estimated value, not an appraised value, for an additional 72 artifacts. He concluded that the descriptions were inadequate to provide even an estimate of the remaining 41 items. Cleland did not have the photographs.

Respondent adopted Cleland's value as to the 19 artifacts appraised, and the 72 artifacts estimated. Respondent determined an allocated value for the remaining items. The valuations may be summarized as follows:

19 Appraised by Cleland	$1,650
72 Estimated by Cleland	10,040
41 Allocated value by respondent	7,928
Total artifact value by respondent	19,618

Herbert Hoover

Herbert Hoover (Hoover) owned an art gallery in San Francisco, California. He specialized in 19th and 20th century paintings and was a senior member of the American Society of Appraisers.[4]

Hoover appraised the donated Ace Powell etchings for respondent at $4,925, as of the date of donation. He researched auction records and consulted private galleries. He found little evidence of comparable sales. He indicated that lesser works of Ace Powell, such as those in issue, had a limited market and were not handled by most auction houses and private galleries.

OPINION

There is no dispute in this case that an actual donation was made to a qualified charitable donee under section 170(c). The only controversy before us is the fair market value of the art items which constitute the donation. The fair market value is the amount petitioners may deduct as a consequence of the contribution. In this respect, respondent's determination of fair market value is presumptively correct, and petitioners bear the burden of disproving that determination. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); Rule 142(a).

Section 1.170A-1(c)(1), Income Tax. Regs., provides that the amount of a charitable contribution made in property other than money shall be the fair market value of the property on the date of donation, reduced as provided in section 170(e)(1).[5] Section 1.170A-1(c)(2), Income Tax Regs., defines fair market value as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts. See *United States v. Cartwright*, 411 U.S. 546, 549 (1973). As reflected in petitioners' Federal income tax returns for the years 1976 and 1977 and the notice of deficiency issued by respondent, the parties take extremely divergent positions as to the fair market values of the donated items.

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[4] Petitioners' expert Monahan did not testify at trial. His report was not entered into the record. The parties stipulated that the Monahan report would have determined a value substantially the same as respondent's expert Hoover.

At the outset, we think certain observations are pertinent. We previously have made clear that the settlement process is more conducive to the proper disposition of disputes such as this because a valuation "is inherently imprecise and capable of resolution only by a Solomon-like pronouncement." See *Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. 441, 452 (1980); *Messing v. Commissioner*, 48 T.C. 502, 512 (1967). At trial, the Court referred the parties to our comments in *Buffalo Tool & Die Mfg Co.* where we admonished that in litigated valuation cases:

> the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise which we suspect each of the parties expects the Court to reach. * * * We do not intend to avoid our responsibilities but instead seek to administer to them more efficiently—a factor which has become increasingly important in light of the constantly expanding workload of the Court. [*Buffalo Tool & Die Mfg. Co. v. Commissioner, supra* at 452.]

Accordingly, we urged counsel for both parties that settlement, rather than trial, might be a more efficacious means to dispose of this case. As the parties did not heed our urging, we must determine the fair market value of the items in issue as of the date of donation.

Indian Artifacts

Petitioners submit that the purchase of 145 Indian artifacts from Masa in June of 1976 was a bargain purchase significantly below fair market value. Furthermore, petitioners assert that the market for Indian artifacts soared during 1976.

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[5] No reduction under sec. 170(e) was required since petitioners satisfied the appropriate holding period concerning the donation of Indian artifacts in 1976 and the etchings in 1977.

Respondent asserts that petitioners and Schoenberg participated in a scheme which was designed to achieve excessive valuations of property donated to MONAC. Furthermore, respondent argues that the valuations within the notice of deficiency are correct, if not in fact generous valuations of the artifacts. We agree.

Petitioners purchased the 145 artifacts from Masa in June of 1976. Schoenberg, acting as their agent, negotiated a purchase price of $12,000. Masa had acquired the artifacts for $9,000 and sold them to petitioners within a year of their purchase. Masa was an experienced dealer who operated out of his home. His practice was to achieve a high rate of inventory turnover. As to these artifacts, Masa turned over his inventory and outperformed the average annual rate of return as estimated by petitioners' expert Johnson. We find no evidence that Masa was forced to sell at distressed prices. Indeed, these artifacts were sold in the normal course of his business and returned an above-average yield. We conclude that petitioners' purchase price of the 145 artifacts reflected their fair market value at that time. We now must determine fair market value of the 132 artifacts donated to MONAC in December of 1976.

As before noted, petitioners bear the burden of proof as to the valuation determinations in the notice of deficiency. *Welch v. Helvering*, 290 U.S. 111 (1933). Rule 142(a). Although we may rely on qualified, expert-opinion evidence, we must weigh such evidence in light of not only the demonstrated qualifications of the experts but all other pertinent circumstances and evidence of value. *Anderson v. Commissioner*, 250 F.2d 242, 249 (5th Cir. 1957), affg. a Memorandum Opinion of this Court.

Respondent, in his determination, relied on Cleland's report. Cleland was a credible witness and impressed us as being the most objective of all of the experts who testified concerning the artifact values. We rely heavily on the probative value of his visual examination.

Johnson and Crawford relied on the descriptions because of the inadequacy of the photographic evidence. Reliance on photographs is not unusual in the appraisal of art.[6] Indeed, photographs generally serve as the basis for appraisals by the Art Advisory Panel to the Internal Revenue Service. Here, however, petitioners failed to supply Johnson and Crawford with reliable photographic evidence. Consequently, we do not accept the values determined by Johnson and Crawford, as their values were based primarily on the descriptions drafted by Schoenberg without the benefit of independent and reliable visual examination. Although Cleland viewed only 19 artifacts, we are persuaded that at least some objective visual inspection was essential to determine an accurate value. Considering the values asserted, we find it incredible that petitioners failed to provide reliable photographic evidence. We find it equally incredible that a mere 19 artifacts were retained and made available by MONAC for inspection. It is unfortunate and somewhat suspect that MONAC did not maintain business records of the subsequent sales of the donated artifacts, as such records would certainly have provided persuasive evidence of value. Furthermore, we note certain other defects in the Johnson and Crawford reports.

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[6] *Gordon v. Commissioner*, T.C. Memo. 1976-274; *Posner v. Commissioner*, T.C. Memo. 1976-216.

The critical date of valuation was the date of donation, December of 1976. Sec. 1.170A-1(c)(2), Income Tax Regs. The Johnson and Crawford reports confused the issue by reference to catalogs of inappropriate years. Johnson used auction catalogs from Sotheby's to determine a price range for each of his tribal groupings.[7] The catalogs were from the years 1979, 1980, 1981, and 1982. Crawford attached public auction catalogs for the years 1979, 1980, and 1981 to his report so as to provide evidence of comparable sales. We find that neither report was prepared to clearly reflect fair market value as of the date of donation, December of 1976.

Johnson employed a group method of valuation. He grouped artifacts according to tribal association. Clearly, the artifacts were of varied quality and value. His method failed to demonstrate the degree of particularity necessary to assist in our determination of value.

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[7] Valuation opinion reports by qualified experts necessarily employ an imprecise method to determine fair market value. Typically, appraisers research sales of comparable items at major auction houses to provide reliable and objective evidence of value. We take judicial notice of the apparent increase of consumer complaints regarding some auction house practices, including a highly publicized civil lawsuit brought against Sotheby's last year by the New York State Attorney General's Office concerning the 1984 auction of rare Judaica. Additionally, the New York City Department of Consumer Affairs, which licenses auction houses, is currently investigating such auction practices. The existence of deceptive trade practices by major auction houses would cast a shadow as to the reliability and objectivity of opinion reports which rely on published sales data from such auction houses. The New York Times, July 31, 1985, at A1, col. 4; The Economist, July 27, 1985, at 16.

Crawford was aided by an assistant in the preparation of his report, although his assistant did not sign the report or testify about it. At trial, Crawford was unsure as to whether or not descriptions were provided by petitioners or drafted by his assistant. In fact, the decriptions within his report were identical to those supplied by petitioners. Due to inadequate visual evidence, Crawford based his report on these descriptions. It is our view, therefore, that Crawford was not competent to testify as to all aspects of his report.

Petitioners argue that as collectors, they were able to purchase the artifacts at a price substantially below fair market value. We have found no evidence in the record to support this contention. In fact, petitioners purchased the artifacts from an experienced dealer who received an above-average rate of return. Petitioners were hobbyists, with an interest in art, who relied on Schoenberg to effectuate all aspects of the subject purchases. The Schoenberg valuations were provided prior to purchase. This certainly implied that a subsequent donation to MONAC would be appraised at a value far in excess of cost. It is our belief that petitioners purchased the artifacts with a clear intent to donate them to MONAC and with some assurance that subsequent donations to MONAC would be appraised at values far in excess of their cost. Indeed, MONAC secured the Fitzgerald and Bates appraisals of the donated artifacts. These appraisals were higher than Schoenberg's valuations of the entire collection, even though the record indicates that the artifacts which were not donated to MONAC were some of the better items in the collection.[8]

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[8] We note the recent legislative "qualified appraiser" regulations mandated by the Tax Reform Act of 1984, Pub. L. 98-369, sec. 155, 98 Stat. 494, 691, and issued as temporary and proposed regulations. Sec. 1.170A-13T(c), Temporary Income Tax Regs. The new substantiation requirements of sec. 170 and regulations thereunder apply to returns filed after Dec. 31, 1984. We note these new requirements because they are illustrative of congessional concern of tax shelter promotions which exploit the deductibility of appreciation in capital gain assets and other situations of gross overvaluations of donated property. The pertinent "qualified appraiser" language, pointedly directed to the situation here, reads as follows:

(c) *Deductions in excess of $5,000 for certain charitable contributions of property made after December 31, 1984*—

* * * * * * *

Additionally, Fitzgerald and Bates were on MONAC's list of appraisers who routinely provided their services to MONAC on a gratuitous basis. Given the circumstances of the instant case, we conclude that their appraisals were not prepared on an independent basis. The artifacts were of average quality at best. Indeed, MONAC retained a mere 19 of the 132 donated artifacts. We are astonished that petitioners could produce no evidence of value received by MONAC from subsequent sales of the donated artifacts.

We agree with respondent's determination that fair market value of the artifacts during December of 1976 was $19,618. This determination of value provides an appreciation rate far in excess of the average annual rate of 20 percent as testified by petitioners' expert Johnson. Petitioners' basis in the artifact collection was $12,000. We have previously determined that petitioners did not receive a bargain purchase of the artifact collection from Masa. Petitioners donated to MONAC 132 of the 145 artifacts which they purchased from Masa. The pro rata basis of the donated artifacts approximates $11,000.[9] Thus, the rate of return provided by our determination of

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(5) *Qualified appraiser*—(i) *In general*. The term "qualified appraiser" means an individual (other than a person described in pargraph (c)(5)(iv) of this section) * * *

(ii) *Exception*. An individual is not a qualified appraiser * * * if the donor had knowledge of facts which would cause a reasonable person to expect the appraiser falsely to overstate the value of donated property (e.g., where an agreement is made between the donor and the appraiser concerning the amount at which the property would be valued and such amount exceeds the fair market value of the property).

* * * * * * *

(iv) *Qualified appraiser exclusions*. The following persons cannot be qualified appraisers with respect to particular property:

* * * * * * *

(C) The donee of the property.

* * * * * * *

(E) Any person whose relationship to any of the persons listed in paragraph (c)(5)(iv)(A) through (D) of this section would cause a reasonable person to question the independence of such appraiser. * * *

[Sec. 1.170A-13T(c), Temporary Income Tax Regs.]

[9] We note that the record indicates that petitioners did not donate some of the better artifacts. Thus a pro rata valuation of basis assigns a higher basis to the donated artifacts than the donated artifacts actually warranted.

value exceeds 78 percent.[10] Assuming, arguendo, petitioners' assertion that Indian artifacts experienced tremendous appreciation during 1976, we find that our determination of value generously accounts for any such appreciation.

Petitioners have totally failed to satisfy their burden of proof. Furthermore, we agree with respondent that a pattern of abuse existed. The facts indicate that Schoenberg was overzealous in his effort to benefit MONAC, and that the Bates appraisal was not prepared on an independent basis. Petitioners should have been aware that the Bates valuation was grossly excessive, particularly given their asserted expertise in Indian art. Petitioners would have been well advised to have heeded a Wall Street maxim concerning propitious market conditions, that "You can make money being a bull and you can make money being a bear, but you can't make money being a pig."[11]

Petitioners assertion of the Bates appraisal on their 1976 tax return was gluttonous.

Etchings

Petitioners purchased 500 etchings by Ace Powell from Masa in February of 1977 for $5,000.[12] Schoenberg was not petitioners' agent in this transaction.

In December of 1977, petitioners donated 194 of their etchings to MONAC and claimed a charitable deduction of $13,975 on their 1977 tax return. Bates provided the appraisal. In March of 1977, Judy commenced employment as a salesperson with Bates at Converse Galleries. During October of 1977, Judy wrote a letter to a potential investor. The letter identified "a few items available for a tax write-off" and represented that each item would "appraise out" at a value between 4 and 5 times investor cost. The obvious message of this sales pitch is that items available for purchase through Converse Galleries would yield a deduction for tax purposes in excess of 4 times investment if donated to a charitable institution. She also informed the potential investor of Schoenberg's active participation in locating additional items for contribution to MONAC in the event that the identified items were no longer available. In our view, the letter indicates that Judy was keenly aware of the tax benefits associated with charitable giving and the correlative importance of appraisals in the substantiation of charitable deductions. Judy left this employment in January of 1978 because she questioned the moral values of Bates. However, Bates appraised the 194 etchings in February of 1978 and petitioners adopted her appraisal on their 1977 tax return. Although Judy was of the opinion that Bates was not of good moral character and that she could not in good conscience continue employment with Bates, petitioners had sufficient confidence in Bates' character to adopt her valuation. This is inconsistency to the point of being ludicrous. As outlined in the MONAC brochure, MONAC had provided two appraisals to petitioners, albeit lower appraisals. Petitioners, unsatisfied with the MONAC appraisals, which were egregious, sought the assistance of Bates and adopted her appraisal because it was the highest. We find this fact to be indicative of petitioners' unrestrained objective; to achieve excessive and abusive valuations of the donated items.

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[10] Net appreciation ($19,618–$11,000) $8,618
Allocated basis .... 11,000 = 78.35% rate of return

[11] Eustice & Lyons, "Federal Income Taxation," 36 N.Y.U. L. Rev. 642, 651 (1961).

[12] For a recent opinion involving contributions by taxpayers of works by Ace Powell, see *Harken v. Commissioner*, T.C. Memo. 1985–468.

We find that Hoover was a credible and knowledgeable witness. He valued the 194 etchings at $4,950. Respondent determined the fair market value to be $5,000. We agree with respondent.

Section 6621(d) Addition to Interest

We now turn to the issue of whether, under section 6621(d), petitioners are subject to an addition to tax. Section 6621(d) provides for an increase in the interest rate due on underpayments where there is a "substantial underpayment" (an underpayment of at least $1,000) in any taxable year "attributable to 1 or more tax motivated transactions." Sec. 6621(d)(1) and (2). This addition applies to interest accruing after December 31, 1984. A "tax motivated transaction" is defined as including "any valuation overstatement (within the meaning of section 6659(c))."[13] Sec. 6621(d)(3)(A)(i). Under section

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[13] Sec. 6659 provides an addition to the tax at graduated rates where an underpayment of at least $1,000 is attributable to a valuation overstatement. Sec. 6659(f) applies the highest rate of 30 percent to valuation overstatements of "charitable deduction property." The provisions of sec. 6659(f) apply to returns filed after Dec. 31, 1984, and do not apply in the instant case. We take judicial notice of the clear congressional intent to penalize individuals, such as petitioners, who grossly overvalue "charitable deduction property."

6659(c), a "valuation overstatement" exists if the value of property claimed on a return is at least 150 percent greater than the amount determined to be the correct valuation of the property.

Section 6621(d)(4) provides the Tax Court with jurisdiction to determine the portion (if any) of a deficiency which is a substantial underpayment attributable to tax motivated transactions. In the instant case, we raise the section 6621(d) issue sua sponte. Section 6621(d) was enacted on July 18, 1984, after the trial of this case. In connection with the enactment of this provision, the Conference Committee stated that:

> The conferees believe that, with this amendment, the Congress has given the Tax Court sufficient tools to manage its docket, and that the responsibility for effectively managing that docket and reducing the backlog now lies with the Tax Court. * * * The Court should * * * *assert, without hesitancy* in appropriate instances, the penalties that the Congress has provided. [H. Rept. 98-861 (Conf.) (1984), 1984-3 C.B. (Vol. 2) 239. Emphasis added.]

Thus, Congress not only intended the Tax Court to raise section 6621(d) on its own motion, but actively urged the Court to do so when appropriate.

In *Law v. Commissioner*, 84 T.C. 985 (1985), we considered the Commissioner's post-trial motion to amend his answer to assert the applicability of section 6621(d). Because the Commissioner asserted numerous alternative grounds as the basis for the deficiencies, not all of which were on the list of "tax motivated transactions," we found that significant legal questions might be raised as to the application of section 6621(d). On that basis, we found that the taxpayer in *Law* would be prejudiced if the Commissioner's motion was granted.

Because we are not faced with a multiplicity of issues, the instant case is clearly distinguishable from *Law*. Overvaluation of property was the sole ground raised by respondent in the notice of deficiency, and valuation was the only matter at issue in the trial of this case. Petitioners had an opportunity to present any evidence available to them that was appropriate to support their valuation claims, and petitioners also were able to present in their briefs all relevant arguments concerning their donation. Thus, it does not work a prejudicial hardship upon petitioners for us to raise this issue post trial. See *Law v. Commissioner, supra* at 990. Rather, petitioners' blatant misuse of the charitable donation provisions by the flagrant overvaluation of the items contributed reflects sinister shadows on the integrity of their scheme. This case is a candid example of the kind of abuse at which section 6621(d) is directly aimed.

In the instant case, it is clear that petitioners participated in a scheme to generate egregious charitable contribution deductions through the gross overvaluation of the items donated. In essence, Schoenberg arranged for petitioners to give the artifacts to MONAC in exchange for documentation to support and add verisimilitude to the overvaluation petitioners claimed on their 1976 return. As to the etchings donated in 1977, the MONAC-arranged appraisals and the Bates appraisals all were prepared in a manner suggestive of tax abuse.

As a result of their overvaluations, a "substantial underpayment" of petitioners' taxes occurred. The resulting deficiency was greater than $1,000. This substantial underpayment was due to petitioners' "valuation overstatements," as the values claimed on petitioners' returns were greater than 150 percent of the amounts we have determined to be the correct valuations of the artifacts and etchings.[14] Consequently, for purposes of section 6621(d), petitioners' involvement in a "tax motivated transaction" resulted in their substantial underpayment of taxes.

As the valuation overstatements were the sole source and cause of petitioners' deficiency, we would be ignoring, and remiss in applying, a congressional mandate should we fail to apply the provisions of section 6621(d) in this instance. However, "we do not intend to avoid our responsibilities" but shall administer to them as we must. Therefore, we find that petitioners are liable for the addition to tax under section 6621(d) on the interest which accrues upon the full amount of the deficiency after December 31, 1984.

Based on the foregoing,

Decision will be entered for the respondent.

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[14] Artifacts, $19,618; etchings, $5,000.

HEINZ MOLSEN, JR., AND CHRISTINA T. MOLSEN, ET AL.,[1] PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 22699–82, 22700–82, 22701–82, 22702–82. Filed September 26, 1985.

M, a cotton merchant, employs the accrual method of accounting and reports its income on a calendar year basis. Some of the cotton is purchased by M through on-call contracts, under which cotton is delivered to M and a provisional price is paid to the seller, but the purchase price remains open until the seller exercises his call right, fixing the price. The purchase price is tied to the market price of cotton futures prevailing at the time the seller calls the contract. In accordance with generally accepted accounting principles and industry-wide practice, M has consistently accounted for its cost of goods sold by valuing ending cotton inventory at market and by bringing its unfixed, delivered, on-call purchases to market at yearend through an accrual to the cost of purchases of an amount determined as if such contracts were called at the end of the year. *Held*:

1. M's method of accounting for such purchases clearly reflects its income; the Commissioner abused his discretion under sec. 446(b), I.R.C. 1954, in determining that M may include only the provisional prices paid for the cotton during the year and that M may not bring the on-call contracts to market.

2. The Tax Court is not empowered to award costs or attorneys' fees under the Equal Access to Justice Act (*McQuiston v. Commissioner*, 78 T.C. 807 (1982), affd. without published opinion 711 F.2d 1064 (9th Cir. 1983), followed), and Ps are not entitled to an award of such costs or fees under sec. 7430, I.R.C. 1954, because they commenced these cases before the effective date of sec. 7430.

Robert W. Ryan, Jr., and *Paul E. Pesek*, for the petitioners.*
William B. Lowrance, for the respondent.

SIMPSON, *Judge*: The Commissioner determined deficiencies in the petitioners' Federal income taxes for 1977 as follows:

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[1] Cases of the following petitioners are consolidated herewith: Frederick G. Molsen and Jayne F. Molsen, docket No. 22700–82; Peter F. Kandel and Barbara M. Kandel, docket No. 22701–82; and Elizabeth Molsen, docket No. 22702–82.

*Brief amicus curiae was filed by Neil P. Gillen, vice president and general counsel of the American Cotton Shippers Association.

Docket No.	*Petitioner*	*Deficiency*
22699–82	Heinz Molsen, Jr., and Christina T. Molsen	$243,048
22700–82	Frederick G. Molsen and Jayne F. Molsen	243,048
22701–82	Peter F. Kandel and Barbara M. Kandel	243,047
22702–82	Elizabeth Molsen	40,483

The issues for decision are: (1) Whether the Commissioner abused his discretion under section 446(b) of the Internal Revenue Code of 1954[2] in determining that a cotton merchant that values its ending inventory at market may not accrue an estimated liability at yearend for cotton purchased under on-call contracts where the cotton has been delivered but the price has not yet been fixed, and (2) whether the petitioners are entitled to an award of costs and attorneys' fees.

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

All of the petitioners maintained their legal residences in Dallas, Texas, at the time they filed their petitions in these consolidated cases. All filed their Federal income tax returns for 1977 with the Internal Revenue Service Center, Austin, Texas. All filed their petitions in this Court on September 10, 1982.

H. Molsen & Co., Inc. (Molsen & Co. or the company), is a cotton merchant engaged in the business of buying and selling cotton throughout the world. Originally formed as a partnership in 1928, Molsen & Co. was incorporated under the laws of the State of Texas in 1966. It has maintained its principal place of business in Dallas, Texas, since its incorporation. During 1977, Molsen & Co. was an electing subchapter S corporation for Federal income tax purposes, and its outstanding shares of stock were owned as follows:

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[2] All statutory references are to the Internal Revenue Code of 1954 as in effect during 1977, unless otherwise indicated.

Shareholder	*Number of shares*
Heinz Molsen, Jr	2,250
Frederick G. Molsen	2,250
Barbara M. Kandel	2,250
Elizabeth Molsen	375

Heinz Molsen, Jr., Frederick G. Molsen, Barbara M. Kandel, and Elizabeth Molsen will sometimes be referred to as the petitioners.

As a cotton merchant, Molsen & Co. purchases cotton from farmers, ginners, and other merchants and then resells the cotton to domestic and foreign textile mills and, occasionally, to other merchants. Cotton is planted between March and June and is harvested from late July to January. The traditional cotton crop year, or season, runs from August 1 to July 31, but cotton merchants buy and sell cotton throughout the year.

There are two basic methods of purchasing cotton: the "spot purchase" and the "forward purchase." In a spot purchase, the cotton is available for immediate delivery to the buyer. In a forward purchase, the seller contracts to deliver the cotton to the buyer at a specified future date.

Both spot purchases and forward purchases can be made at either "fixed" or "on call" prices. In a fixed price contract, the price per pound of cotton is established or "fixed" on the day the agreement is entered into by buyer and seller. In an on-call contract, the price remains open or "on call" until the seller exercises a call right granted by the contract. The purchase price is ultimately determined by a formula tied to the market price of cotton: the contract price is a specified number of "points"[3] above or below the futures price for the base quality cotton[4] traded on the New York Cotton Exchange for a particular month for future delivery. Such price is then adjusted to reflect any difference in quality between base quality cotton and the cotton actually delivered under the contract. Cotton is traded on the futures market for the months of March, May, July, October, and December. The seller may exercise the call right at any time between the execution of the contract and the day preceding the first

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[3] A "point" is one/one-hundredth of a cent.

[4] The term "base quality cotton" refers to the type of cotton traded on the New York Cotton Exchange: strict low middling 1-1/16 inch staple length with a micronaire of 3.5 through 4.9.

"notice day" of the designated call month. The first notice day generally falls on about the fifth day preceding the first day of the call month. For example, on December 8, 1977, Molsen & Co. entered into an on-call purchase contract which provided for a contract price of "850 points off[5] July 1978, futures price at time of seller's fixation." Under the contract, the seller had until about June 25, 1978, to call and fix the price, and he would receive a price per pound of 8.5 cents less than the July futures price on the day he exercised the call. If the seller failed to exercise the call, the price would be determined by reference to the futures settlement price at the close of the last day before the first notice day of a July 1978 futures contract. In a large purchase, Molsen & Co. might permit the seller to call the price in increments of 100 bales per call, with the result that the price of the entire contract would not be fixed until the seller made several calls or the first notice day arrived. Cotton bought on call and delivered to the cotton merchant may be resold by the merchant long before the original seller fixes the price and receives payment in final settlement of the contract.

In most on-call cotton purchases, the price is a specified number of points off (below) the futures market price. All of the Molsen & Co. on-call purchase contracts at issue here provided for a price off the price of July 1978 futures. The exact price terms of on-call cotton purchase contracts are influenced by a competitive marketplace. Molsen & Co. bases the price terms of its on-call purchase contracts on the difference between the spot price and the futures price existing at the time it enters into the contract. The "spot price" of cotton is the price at which cotton can be purchased for cash in the open market for immediate delivery. The difference on any given day between the spot price of cotton and the futures price for cotton traded on the New York Cotton Exchange for a particular month is called the "basis." For example, if on December 1, 1977, the spot price of cotton was 45 cents per pound and the market price for July 1978 futures was 50 cents per pound, the basis would have been 5 cents (500 points). The basis fluctuates over time but not to the same extent as the futures price, which may fluctuate by as much as 2 cents per pound in a single day. By looking to the basis existing at the time it enters into an on-call contract, Molsen & Co. determines the price terms of the contract; in our example, the price formula would be 500 points off July 1978 futures.

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[5] A price "off" a futures month refers to a price the specified number of points below the futures price. A price "on" a futures month refers to a price the specified number of points above the futures price.

Under an on-call purchase contract, the cotton merchant may or may not agree to make a provisional payment, or advance, to the seller upon delivery of the cotton, with the balance (if any) to be paid when the seller fixes the price. Delivery is made by transferring a negotiable warehouse receipt for each bale of cotton sold. The transfer of the warehouse receipts also effects the transfer of legal title to the cotton. The amount of the provisional payment is determined in different ways depending on where the cotton is purchased: in some areas of the country, farmers demand a provisional payment bearing some relation to the amount that they would receive if they pledged their cotton in return for an agricultural loan from the Federal Government; in other areas, farmers request a provisional payment determined under a formula tied to the futures market. If the seller receives a provisional payment, he is paid any balance due him when he fixes the price.

The on-call purchase contract has been used since the 1930s. It arose in response to the introduction of a Federal Government price-support program for cotton farmers under which the Secretary of Agriculture establishes loan values for cotton based on the grade, staple, and micronaire of the cotton. The base quality cotton for the Government loan program is the same as the base quality cotton traded on the New York Cotton Exchange. The Government loan program affords the farmer the opportunity to pledge his cotton to the Government in return for the receipt of the Government loan value for such cotton, thereby creating a floor or minimum price for the cotton. For the next 10 months (in some cases, 18 months), the farmer has the right to redeem his cotton from the Government by paying back the loan value received, plus the accrued carrying charges for interest, storage, and insurance. If he redeems the cotton, the farmer is free to sell it on the open market at the then-prevailing market price. If he fails to redeem the cotton, the farmer has, in effect, sold his cotton to the Government at a price equaling its loan value. Thus, participation in the Government loan program guarantees the farmer a minimum price while allowing him to wait 10 or 18 months for a rise in the market value of his cotton which would enable him to get a higher price. In the past, during periods in which the spot price of cotton has approximated the loan value of such cotton, farmers tended to participate in the Government loan program in hopes of a rise in the market. As farmers pledged their cotton under the loan program, it became difficult for cotton merchants and textile mills to buy cotton. Therefore, to secure themselves a supply of inventory, they instituted the on-call purchase contract. The on-call purchase contract is more advantageous to farmers than the Government loan program because it permits farmers to secure the full benefit of a market rise without having to pay any carrying charges.

As a general rule, farmers sell their cotton under on-call contracts when the spot, or market, price of cotton is close to its Government loan value. Conversely, when the spot price of cotton is high, well above its loan value, farmers tend to want to "lock in" the high price through a fixed price contract. From the end of World War II up to about 1970, and particularly during the 1960s, the Government maintained cotton loan values (and thus cotton prices) at a very high level. Large cotton surpluses developed as farmers began, in effect, to grow cotton for the loan. The spot price of cotton stayed at the loan level, and the cotton export market dried up. On-call purchases were infrequent because it was unlikely that the futures price of cotton would rise above the loan level. In the early 1970s, the Federal Government began an extensive program to dispose of its surplus, to cut back on cotton acreage, and to move toward a free market system. As the surpluses disappeared, the cotton markets moved away from the support prices, and with the increasing risk of market fluctuations, the futures market became more active and the number of on-call purchases and sales became significant. In 1977 and at the time of trial, use of the on-call purchase contract was a common, accepted, and industry-wide practice.

Cotton merchants, including Molsen & Co., may engage in hedging transactions with respect to their fixed price purchases and fixed price sales. Fixed price contracts may be hedged by entering into an offsetting transaction in the cotton futures market. Thus, if a cotton merchant purchases 100 bales of cotton at a fixed price, the merchant would sell one contract (which consists of 100 bales) on the cotton exchange for future delivery. Cotton merchants do not hedge unfixed, on-call purchases.

Molsen & Co. has always reported its income on a calendar year basis for Federal income tax purposes. It uses a fiscal year ending July 31 for financial reporting purposes. Technically, Molsen & Co. employs a hybrid method of accounting: the day-to-day operations of the company are recorded on a cash basis, but at yearend, adjusting entries are made to all material accounts (such as accounts receivable, accounts payable, and purchases) to effectively place the company on an accrual basis for income tax purposes.

Molsen & Co. uses inventories and computes its cost of goods sold by adding the year's cotton purchases to opening inventory—thereby indicating the total cost of goods available for sale—and then subtracting ending inventory. The ending inventory consists of sold and unsold cotton to which the company has title at yearend. The company values its ending inventory at "market": inventory under a sales order (i.e., sold but not yet delivered) is valued at the contract sale price less certain (unspecified) charges; unsold inventory is valued at its current market value, determined by reference to several factors, including daily spot price quotations published by the Department of Agriculture and the price of futures contracts traded on the New York Cotton Exchange. The market value so determined may be higher or lower than the actual cost of the cotton inventory. A year's ending inventory figure is used as the opening inventory figure in the following year.

Cotton purchases are accounted for at cost under an accrual method: during the course of the year, the purchases account is debited by the amounts paid under fixed price contracts, advanced as provisional payments under delivered, on-call contracts, and paid in final settlement of delivered, on-call contracts that have been fixed by the end of the year; at yearend, in the event of a rising market, Molsen & Co. accrues an additional amount to the purchases account (by debiting purchases and crediting accounts payable) to account for the additional money potentially due to sellers under delivered, on-call purchase contracts that have not yet been fixed.[6] Cotton merchants sometimes refer to this accrual calculation as bringing the unfixed, delivered, on-call purchases "to market," but in fact, the purchase obligations are not accrued at the yearend market (or spot) value of the purchased cotton. Rather, the amount of the accrual is determined in accordance with the price terms of each unfixed, delivered, on-call purchase contract, in light of the market price on December 31 of futures of the designated call months: generally, Molsen & Co. calculates the amount that it owes under the contracts (without regard to amounts previously advanced as provisional payments) as if the sellers had elected to call and fix the prices on December 31, and then accrues the difference between such amount and the provisional payments.[7] Although the accrual technically does not peg the cost of unfixed, delivered, on-call purchases at the yearend market value of cotton, we may hereinafter refer to the accrual as bringing such purchases "to market" for brevity's sake and because the purchase cost as accrued is tied to the yearend market price of futures.

Molsen & Co. reverses the yearend accruals for unfixed, delivered, on-call purchases shortly after the start of the following year by debiting accounts payable and crediting the purchases account. Reversing the accrual entries prevents the duplication in the following year of the previously accrued cost of such purchases. When each seller actually fixes the price of his cotton, Molsen & Co. pays the difference between the called price and the amount provisionally advanced, and it debits the purchases account and credits the cash account for the additional amount paid.

Molsen & Co. has always valued its inventory at market. Likewise, the company has always accrued a liability to its purchases account at yearend for the unpaid balance (if any) due under unfixed, delivered, on-call purchase contracts. These adjustments are made for financial accounting purposes as well as for tax accounting purposes. However, due to the fact that the cotton season ends on July 31 of each year, Molsen & Co.'s inventory is much lower at the close of its fiscal year on July 31. Furthermore, the company rarely has any unfixed, delivered, on-call purchases at the close of its fiscal year because it typically ends the season with on-call purchases based on July futures; in only a few, isolated instances has cotton been delivered and sold to Molsen & Co. on-call in one season based on October futures, which falls in the next season. Consequently, no adjustment is usually necessary in the preparation of the company's financial statements to accrue amounts potentially owing on unfixed, delivered, on-call purchases. None of the company's delivered, on-call purchases remained unfixed on July 31, 1978.

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[6] In the event that the cotton market falls by yearend to the point where the provisional payment exceeds the amount due the seller under an unfixed, delivered, on-call purchase contract on Dec. 31, and assuming that the provisional payment is not a guaranteed minimum price, Molsen & Co. would, theoretically, credit the purchases account and debit accounts receivable by the amount of such difference due it by the seller. However, there is no evidence that Molsen & Co. has ever experienced this situation.

[7] As will be discussed in the text, *infra*, Molsen & Co. calculated the accrual in slightly different ways for the two groups of its delivered, on-call purchases that were unfixed on Dec. 31, 1977, and employed certain average figures in its computations.

Molsen & Co.'s method of accounting for its cost of goods sold conforms to generally accepted accounting principles and to longstanding industry-wide practice. Most, if not all, cotton merchants value their yearend inventories at market for financial and tax accounting purposes, and this practice has been explicitly recognized and permitted by the Commissioner since 1926. Likewise, most, if not all, cotton merchants bring their unfixed, delivered, on-call purchases to market if they have any at the end of their fiscal or taxable years. Unlike Molsen & Co., many cotton merchants, either before or since 1977, have adopted identical years for tax and financial reporting purposes and have selected years corresponding more closely to the traditional cotton season—for example, years ending on May 31, June 30, July 31, or August 31. Such merchants rarely have unfixed, delivered, on-call purchases to bring to market at the end of their taxable years. However, such purchases are brought to market on interim financial statements prepared during the course of the year for company use or to secure bank financing.

Cotton merchants sell cotton on-call in addition to buying cotton on-call. An on-call sale operates much like an on-call purchase; all particulars of the transaction are fixed with the exception of the price, which remains "on-call." The price is a negotiated number of points on or off the price of a futures contract for a call month traded on the New York Cotton Exchange. In an on-call sale, unlike an on-call purchase, the buyer (typically a textile mill) has the call, which may be exercised anytime between the execution of the contract and the first notice day of the call month. Some cotton merchants receive a provisional payment and ship the cotton to the buyer before the price has been fixed. Where the price of cotton sold and delivered on-call has not been fixed by yearend, cotton merchants bring the sale "to market" at the close of the year by accruing the amount that would be due it if the buyer had elected to call the price on the last day of the year. Molsen & Co. engages in on-call sales, but does not, as a rule, ship cotton to a buyer before the buyer has fixed the price. Consequently, Molsen & Co. normally has no unfixed, delivered, on-call sales contracts at yearend; in the event that the company does, it brings such sales to market in the same manner as it brings its on-call purchases to market. Apparently, Molsen & Co. and other cotton merchants do not accrue unfixed, on-call sales at yearend where the cotton has not yet been shipped; but, since the merchants have title to such cotton at the end of the year, it is included in ending inventory at its market value.[8]

In 1977, Molsen & Co. purchased 1,199,915 bales of cotton, of which 1,060,990 were purchased in the United States. On December 31, 1977, the price of 37,706 bales bought on-call and delivered to the company remained unfixed. Such on-call purchases are divisible into two groups: the Texas contracts, totaling 17,021 bales, and the Memphis territory[9] contracts, totaling 20,685 bales. Each of the Texas and Memphis territory contracts provided for a price of a specified number of points off July 1978 futures, with adjustments for grade, staple, and micronaire, and each of the contracts provided for a provisional payment. Under a Texas contract, the provisional payment equaled the Government loan value of the cotton less a 50 point "invoicing and outturn charge," and constituted a guaranteed minimum price for the cotton. The Texas farmer was therefore guaranteed the cotton's loan value in the event of a subsequent decline in the futures market. Under some of the Memphis territory contracts, the provisional payment was

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[8] It is not clear from the record whether cotton merchants treat such cotton as "sold" cotton (sold but undelivered) that is valued at its sales price or as "unsold" cotton that is valued at its market value. *If such cotton is viewed as sold*, it is presumably necessary to determine its sales price as if the price was fixed on the last day of the year—just as the merchants calculate the accrual to sales for unfixed, delivered, on-call sales.

[9] The Memphis territory includes the States of Tennessee, Arkansas, Louisiana, Mississippi, and Missouri.

40 cents per pound regardless of the actual loan value of the delivered cotton, whereas under the remaining contracts, the provisional payment equaled the Government loan value. Except for two contracts, the provisional payment advanced under a Memphis territory contract was not a guaranteed minimum price.

Molsen & Co. filed a Small Business Corporation Income Tax Return for the calendar year 1977 on which it reported gross sales, cost of goods sold, and gross profit from sales as follows:

Gross sales	$325,894,477
Less: Returns and allowances	2,296,266
	323,598,211
Less: Cost of goods sold	317,078,994
Gross profit from sales	6,519,217

The company reported total income of $6,772,017, and after subtracting deductions totaling $5,356,303, reported taxable income of $1,415,714.

The company's cost of goods sold, as reported on its 1977 return, was computed as follows:

Beginning inventory	$104,323,282
Plus: Purchases	251,095,008
	355,418,290
Plus: Freight	8,149,007
Compress charges and controlling fees	6,042,641
Interest and exchange	4,292,541
Insurance on cotton	824,411
Purchase commissions	268,681
Customs and duties	48,579
	375,044,150
Less: Ending inventory	57,965,156
Cost of cotton sold	317,078,994

In computing the value of its ending inventory, Molsen & Co. valued unsold inventory at its market value on December 31, 1977, and sold-but-undelivered inventory at its sales price. The price of cotton and cotton futures was rising at the end of 1977. By December 31, 1977, the price of July 1978 futures for base quality cotton had risen to 55.40 cents per pound. To bring unfixed, delivered, on-call purchases to market on December 31, 1977, Molsen & Co. accrued an additional $1,099,464.58 to its purchases account, consisting of $189,324.58 that would have been due under the Texas contracts and $910,140 that would have been due under the Memphis territory contracts had the sellers under such contracts fixed their prices on December 31. The additional $1,099,464.58 was then included in the purchases figure to increase the company's cost of goods sold by such amount and to reduce its gross profit and taxable income by such amount.

Molsen & Co. employed different methods to calculate the amounts potentially due under the Texas and Memphis territory contracts. In computing the accrual for the Texas contracts, the company first determined that the weighted average of the different buying bases (the number of points off July 1978 futures) provided in the Texas contracts was 853 points, or 8.53 cents, per pound. The company then deducted 8.53 cents from 55.40 cents, the December 31, 1977, price of July 1978 futures, to arrive at a price of 46.87 cents per pound for base quality cotton. The difference between 46.87 cents and the loan value of base quality cotton in Texas, 44.60 cents per pound, was 2.27 cents. By multiplying 2.27 cents by 8,340,290 pounds (the approximate weight of 17,021 bales of Texas cotton[10]), the company arrived at $189,324.58 as the amount that it would have owed in addition to the previously advanced provisional payments if the Texas contracts had been called on December 31, 1977. To compute the accrual for the Memphis territory contracts, the company separately determined the amount per pound potentially due under each contract by subtracting the provisional payment actually advanced from the price on December 31, 1977, as determined in accordance with the contract. The average amount due was 880 points, or 8.8 cents, per pound. By multiplying 8.8 cents by 10,342,500 pounds (the approximate weight of 20,685 bales of Memphis territory cotton[11]), the company determined that it would have owed $910,140 more if the sellers had fixed their prices on December 31, 1977.

All of the sellers under the Texas and Memphis territory contracts exercised their call rights and fixed their prices by June 23, 1978; Molsen & Co. paid approximately $1,839,633.70 in 1978 in final settlement of the Texas and Memphis territory contracts.

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[10] A bale of Texas cotton weighs approximately 490 pounds.

[11] A bale of Memphis territory cotton weighs approximately 500 pounds.

The petitioners reported their distributive shares of Molsen & Co.'s reported taxable income on their Federal income tax returns for 1977. In his notices of deficiency, the Commissioner determined that Molsen & Co. could not bring its unfixed, delivered, on-call purchases to market on December 31, 1977, by accruing $1,099,465 to purchases in computing its cost of goods sold, because, on December 31, 1977, such purchase contracts were open-ended contracts under which Molsen & Co. had only a contingent liability for additional costs. The Commissioner therefore limited purchases to the $249,995,543 actually paid by Molsen & Co. in 1977 and increased the company's taxable income by $1,099,465. There is no evidence that the Commissioner changed the company's method of valuing opening and ending inventories at market.

OPINION

Section 446 provides that taxable income shall be computed under the method of accounting regularly used by the taxpayer in computing his income and keeping his books, but if no method has been regularly used by the taxpayer or if "the method used does not clearly reflect income," the computation shall be made under such method as, in the opinion of the Commissioner, does clearly reflect income. The term "method of accounting" includes not only the taxpayer's overall method but also the accounting treatment of any item. Sec. 1.446-1(a)(1), Income Tax Regs. Molsen & Co., a cotton merchant, accounts for its taxable income on an accrual basis and employs a taxable year ending December 31. In accordance with generally accepted accounting principles and industry-wide practice, the company has historically and consistently accounted for its cost of goods sold by valuing ending cotton inventory at market and accruing to the cost of purchases the additional amount that would be payable by it under its unfixed, delivered, on-call purchase contracts were the cost of such purchases fixed on December 31. Since 1926, the Commissioner has expressly permitted cotton merchants and other dealers in commodities to value their ending inventories at market value even though market value may exceed the inventories' actual cost. See Rev. Rul. 74-227, 1974-1 C.B. 119, which updated, restated, and superseded S.M. 5693, V-2 C.B. 20 (1926). However, the Commissioner has recently ruled that cotton merchants may not include the additional amounts (if any) payable under on-call purchase contracts in the cost of cotton purchases unless the cotton producers have called the prices during the taxable year. Rev. Rul. 81-298, 1981-2 C.B. 114.[12] The primary issue for decision is therefore whether Molsen & Co.'s method of accounting for its unfixed, delivered, on-call purchases clearly reflects its income so that the Commissioner was arbitrary and abused his discretion in determining that the company's method should be changed.

Section 446 vests the Commissioner with wide discretion in determining whether a particular method of accounting clearly reflects income, and a heavy burden is imposed upon the taxpayer to overcome a determination by the Commissioner in this area. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979); *United States v. Catto*, 384 U.S. 102, 114 (1966); *Commissioner v. Hansen*, 360 U.S. 446, 467 (1959); *Lucas v. Structural Steel Co.*, 281 U.S. 264, 271 (1930). However, it is a well-established principle that the Commissioner cannot require a taxpayer to change from an accounting method which clearly reflects income because the Commissioner considers an alternate method to more clearly reflect income. See, e.g., *St. James Sugar Co-op, Inc. v. United States*, 643 F.2d 1219 (5th Cir. 1981); *Bay State Gas Co. v. Commissioner*, 75 T.C. 410, 417 (1980), affd. 689 F.2d 1 (1st Cir. 1982); *Auburn Packing Co. v. Commissioner*, 60 T.C. 794, 798–800 (1973); *Garth v. Commissioner*, 56 T.C. 610, 618 (1971).

Gross income, in a merchandising business, means total sales less cost of goods sold (the gross profit from sales), plus any income from investments and from incidental or outside operations and sources. Sec. 1.61-3, Income Tax Regs.; Form 1120. The cost of goods sold during a year is determined by subtracting inventory on hand at the end of the year from the total inventory on hand at the beginning of the year and the cost of purchases. Schedule A, Form 1120. The use of inventories is a key feature of the accrual method of accounting. Inventories are intended to insure a clear reflection of the year's income by matching sales during the taxable year with the purchase costs attributable to those sales; costs attributable to inventory remaining on hand at the end of the year are not expensed in the year incurred, but are, in effect, deferred until the year in which such inventory is sold. See *Photo-Sonics, Inc. v. Commissioner*, 357 F.2d 656, 657–658 (9th Cir. 1966), affg. 42 T.C. 926 (1964); *All-Steel Equipment Inc. v. Commissioner*, 54 T.C. 1749, 1751 (1970), affd. per curiam on this issue 467 F.2d 1184 (7th Cir. 1972). Where inventories are employed, purchases and sales must be computed on the accrual method (unless another method is authorized by the Commissioner) in order to avoid the distortion of income. Sec. 1.446–1(c)(2), Income Tax Regs.; *Stoller v. United States*, 162 Ct. Cl. 839, 845, 320 F.2d 340, 343 (1963).

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[12] The Commissioner issued Rev. Rul. 81-298, 1981-2 C.B. 114, in response to his investigation of Molsen & Co.'s method of accounting for its on-call purchase contracts.

Inventories are most commonly valued at either (1) cost or (2) the lower of cost or market. Sec. 1.471–2(c), Income Tax Regs. Use of the latter method accelerates the recognition of unrealized losses on the inventory: where the market value of the inventory on hand at yearend has fallen below its original cost, the decline is recognized as a loss for income tax purposes even though the inventory has not been sold during the year. *St. James Sugar Co-op, Inc. v. United States, supra* at 1226; *D. Loveman & Son Export Corp. v. Commissioner*, 34 T.C. 776, 798 (1960), affd. 296 F.2d 732 (6th Cir. 1961). The lower of cost or market method, expressly approved by the regulations, is a recognized exception to the principle of annual accounting that only closed transactions occurring during the taxable year may be reflected on the year's tax return. *St. James Sugar Co-op, Inc. v. United States, supra.*

Molsen & Co.'s method of valuing ending inventory at market, whether higher or lower than cost, results in the recognition of unrealized gains as well as unrealized losses on the inventory. Valuation at market is the longstanding practice of cotton merchants. Expressly authorized for dealers in securities by section 1.471–5 of the regulations, such method was originally approved for cotton merchants and other dealers in commodities in S.M. 5693, *supra*, and was reapproved in Rev. Rul. 74–227, *supra*. The method was approved on the basis of a brief submitted on behalf of cotton merchants and made a part of A.R.M. 135, 5 C.B. 67, 69 (1921), wherein it was explained:

> The bales bought by the cotton merchant from day to day at different prices during the course of a season consist of every known grade of cotton. * * * The identity of the individual bale is not retained, and the cost of the

> individual bale is not kept by the cotton merchant and can not be, owing to concentration of all cotton bought and continued additions and shipments from the whole lot, but the value of the cotton on hand can always be determined because of the market quotations and the fact that the commodity is liquid and immediately convertible into cash.
>
> At the close of the year, either fiscal or calendar, the cotton merchant takes an inventory of the cotton on hand. This cotton consists of bales purchased from the first day of the season to the last and represents a wide difference in price paid. The universal practice has been to inventory at market, because that tells the real value of his commodity; further, because the identity of the bale and the matter of cost can not be determined, hence it is impossible to take it other than at the market price.

The Commissioner therefore recognized that valuation of cotton inventory at market conforms to the industry-wide practice of many years and to the best accounting practice in the trade and is the only practical method of arriving at a true and correct reflection of the cotton merchant's income. Rev. Rul. 74-227, *supra*; S.M. 5693, *supra*.

By bringing its unfixed, delivered, on-call purchase contracts to market at the end of its taxable year, Molsen & Co. reduces the size of the gain or loss recognized as a result of its inventory valuation method. The spot (market) price and the futures price of cotton tend to move in tandem. Thus, in a rising market, as the market value of the inventory increases, Molsen & Co.'s potential liability under its unfixed, on-call purchase contracts increases. The accrual to purchases of such liability increases the cost of goods sold and thereby reduces the gross income of the company. In a falling market, Molsen & Co.'s potential liability under its unfixed, on-call contracts declines as the market value of the cotton inventory declines. If the market price were to fall below the amount which Molsen & Co. advanced as a provisional payment under its unfixed, on-call purchases, the amount potentially receivable by the company from the sellers (assuming, as under most of the Memphis territory contracts, that the provisional payment was not a guaranteed minimum price) would be offset against the loss recognized on the inventory. At the end of 1977, the market and futures prices of cotton were rising, and Molsen & Co. accrued $1,099,464.58 to the cost of purchases as the amount that it would have owed on December 31 had the sellers under the Memphis territory and Texas contracts, which were unfixed, called their prices on that day. As it turned out, the market continued to rise, and Molsen & Co. eventually paid about $1,839,633.70 in 1978 in final settlement of the contracts.

The Commissioner contends that purchases are an expense subject to the "all events" test of sections 1.446–1(c)(1)(ii) and 1.461–1(a)(2) of the regulations, which govern the timing of deductions under the accrual method. Applying such test to the unfixed, delivered, on-call purchase contracts involved here, the Commissioner argues that the provisional payments advanced in 1977 are includable in purchases but that no yearend accrual may be made for the estimated additional amounts due under the contracts because Molsen & Co.'s liability for such additional amounts was contingent until the time that the sellers actually called the price. The petitioners, on the other hand, contend that the Commissioner acted arbitrarily and abused his discretion in disallowing the yearend accrual for the unfixed, on-call purchases because such accrual conformed to industry-wide practice and to generally accepted accounting principles, was consistently applied year after year, and, most importantly, was necessary in order to clearly reflect the company's income. The petitioners present a variety of arguments, but their basic position is that the Commissioner, having recognized the need of cotton merchants for, and the practice of, valuing ending inventory at market, was arbitrary in rejecting their companion practice of bringing unfixed, delivered, on-call purchases to market; to value their inventories at market in any event and to deny them the opportunity to bring their purchase costs to market results, they maintain, in a substantial distortion of income.

As stated above, if a taxpayer uses inventories, purchases must be accounted for under the accrual method in order to accurately reflect the cost of goods sold during the year. Sec. 1.446–1(c)(2), Income Tax Regs. The all events test relied upon by the Commissioner has long been a cornerstone of the accrual method of accounting for Federal income tax purposes. See, e.g., *Brown v. Helvering*, 291 U.S. 193 (1934); *Lucas v. American Code Co.*, 280 U.S. 445 (1930); *United States v. Anderson*, 269 U.S. 422 (1926). The regulations describe the accrual method as follows:

> Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred which fix the right to receive such

> income and the amount thereof can be determined with reasonable accuracy. Under such a method, deductions are allowable for the taxable year in which all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. * * * [Sec. 1.446–1(c)(1)(ii), Income Tax Regs.]

This description of the accrual method is repeated in the regulations under section 451, insofar as it pertains to the accrual of income, and in the regulations under section 461, insofar as it pertains to the accrual of deductible expenses.

In our view, the Commissioner's reliance, in part, on section 1.461–1(a)(2) of the regulations is misplaced. Although purchases are an "expense" in the colloquial sense, it is well settled that they are not a "deduction" within the meaning of section 461 and that they are not subject to the rules governing deductions under such section. Purchases are taken into account in computing the cost of goods sold, which is an offset, or exclusion, employed in the computation of gross profit and gross income (section 1.61–3(a), Income Tax Regs.); whereas, throughout the Code, the term "deduction" is used to refer to amounts subtracted from gross income to arrive at taxable income. *Curtis Gallery & Library, Inc. v. United States*, 388 F.2d 358, 361 (9th Cir. 1967); *B.C. Cook & Sons, Inc. v. Commissioner*, 65 T.C. 422, 428–432 (1975), affd. per curiam 584 F.2d 53 (5th Cir. 1978), and cases cited therein; *National Home Products, Inc. v. Commissioner*, 71 T.C. 501 (1979).

Such distinction was recognized in *Max Sobel Wholesale Liquors v. Commissioner*, 69 T.C. 477 (1977), affd. 630 F.2d 670 (9th Cir. 1980). In that case, the taxpayer, in violation of State law, made sales of liquor and wine to selected customers at posted prices with the understanding that such customers would receive a credit to be used for future purchases or an additional bottle of each case purchased. As the additional bottles were delivered, their cost was charged to the cost of goods sold. Section 162(c)(2) disallows a deduction for an "illegal bribe, illegal kickback, or other illegal payment" otherwise deductible under section 162(a). However, we held that such limitation was not applicable because the cost of the additional bottles was a part of the cost of goods sold. 69 T.C at 484–486. See also *Pittsburgh Milk Co. v. Commissioner*, 26 T.C. 707 (1956). Similarly, in *National Home Products, Inc. v. Commissioner, supra*, we determined that casualty losses of inventories are not deductions subject to the "reasonable prospect of recovery test" contained in section 1.165–1(d)(2)(i) of the regulations, which determines the year of deductibility of casualty losses under section 165. The Commissioner had argued that it would be inconsistent to allow inventory losses to be reflected in the cost of goods sold for a year at the end of which there was a reasonable prospect of recovery of such losses while other losses would be disallowed under similar circumstances. We disagreed, stating that "This is simply recognition of the fact that use of inventories in computing gross income for both book and tax purposes is unique and warrants use of different rules to correctly reflect income."[13] 71 T.C. at 530.

The Commissioner has, in his regulations, also recognized that in some industries, the all events test is not to be applied in determining the costs of inventories. For example, section 1.471–6, Income Tax Regs., permits livestock raisers and farmers to value livestock inventory under the "unit-livestock-price method." Such method permits the livestock raiser to estimate the cost of the animals in inventory through a classification system based on the age and kind of the animal "so that the unit prices assigned to the several classes will reasonably account for the normal costs incurred in producing the animals within such classes." Sec. 1.471–6(e), Income Tax Regs. Once established, the unit prices and classifications selected by the livestock breeder must be consistently applied in all subsequent taxable years in the valuation of the livestock inventories. Sec. 1.471–6(f), Income Tax Regs. We have recognized that use of the unit-livestock-price method "is at best an approximation," but that it serves "a useful purpose in that it greatly eases the bookkeeping burden on many taxpayers without an inordinate sacrifice in accuracy." *Auburn Packing Co. v. Commissioner*, 60 T.C. at 801.

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[13] In *ABKCO Industries, Inc. v. Commissioner*, 56 T.C. 1083 (1971), affd. 482 F.2d 150 (3d Cir. 1973), we applied sec. 461 and the regulations thereunder to bar the taxpayer's accrual of a contingent liability for royalties as a cost of inventory. However, in that case, we did not explicitly address the issue of whether sec. 461 is applicable to an inventoriable cost; apparently, the application of such section was presumed by both parties to the case. *ABKCO* is distinguishable from the present case for two reasons: First, the taxpayer's liability for the royalties which it sought to accrue and the amount thereof were much more speculative than the accruals of Molsen & Co.; and second, there is no evidence that the taxpayer in *ABKCO* valued its ending inventory at market.

Similarly, section 1.471–8 of the regulations permits retail merchants to employ the "retail method" of inventory accounting. Under the retail method, the retail value of the inventory on hand at the close of the year is reduced by a mark-on percentage to arrive at the approximate cost of such inventory. The mark-on percentage (which is an average computed in accordance with the regulations) reflects the amount added to cost to cover selling and other expenses and profit margin. Sec. 1.471–8(a), Income Tax Regs. Although the cost assigned to any particular inventory under the retail method is merely an approximation, it is an accepted and popular method because it is simpler than other methods, particularly for the larger retailer. See R. Hoffman & H. Gunders, Inventories 325–326 (2d ed. 1970).

Both the unit-livestock-price method and the retail method are sanctioned because the practical accounting problems encountered by those in the livestock raising and retail industries have been recognized. Both methods entail some degree of estimation which will ultimately affect the computation of cost of goods sold and, thus, income. However, if consistently applied, such methods result in a clear reflection of income.

Here, the unique accounting needs and practices of the cotton merchants have similarly led to a deviation from the general rules governing the valuation of inventories and the calculation of income. The Commissioner has made no attempt to show how such practices fail to clearly reflect Molsen & Co.'s income. Of course, the recognition of Molsen & Co.'s liabilities for its unfixed, on-call purchases involves some degree of approximation, but the degree of such approximation and the contingency of the liabilities are no greater than the degree of approximation and the contingency attached to the recognition of unrealized income because of the inventory's increased value.

The facts of this case present a persuasive example of why the all events test should not always be applied in determining the costs of inventory. Generally, income is not taxable until it is realized, and it is not realized until it has been received and the offsetting expenses have been paid or incurred. However, the practice of valuing the inventories of a cotton merchant at market can result in the taxation of unrealized income. For example, if a merchant purchases a pound of cotton for a fixed price of 45 cents, and if that cotton is in his inventory at the end of the year and has a value of 50 cents at that time, he is taxable on 5 cents of unrealized income. In that situation, although the income is unrealized, the merchant does actually stand to make a gain, but if he purchased such cotton under an on-call contract and advanced 45 cents as a provisional payment, he does not, in fact, stand to make such gain. It is utterly unrealistic to treat his cost as merely the 45 cents; if the law recognizes that the cotton has a value of 50 cents, the law must also recognize that its cost is more than 45 cents. Since the value of the inventory is not based upon actual cost, but reflects the market value of the products, it would be paradoxical to apply the all events test and require the merchant to compute the cost of his inventory on the basis of his actual expenditures. The observations of Judge Opper in *Pacific Grape Products Co. v. Commissioner*, 17 T.C. 1097, 1110 (1952) (Opper, J., dissenting), revd. 219 F.2d 862 (9th Cir. 1955), are particularly apposite here:

> The practice of disapproving consistent accounting systems of long standing seems to me to be exceeding all reasonable bounds. * * * Methods of keeping records do not spring in glittering perfection from some unchangeable natural law but are devised to aid business men in maintaining sometimes intricate accounts. If reasonably adapted to that use they should not be condemned for some abstruse legal reason, but only when they fail to reflect income. * * *

The Commissioner relies heavily on the Supreme Court's decision in *Thor Power Tool Co. v. Commissioner*, *supra*, giving him broad authority to determine the accounting methods to be used by taxpayers, but the facts of that case were significantly different. There, the taxpayer sought to writedown its "excess" inventory to what it estimated to be its net realizable value, even though the taxpayer continued to hold such inventory for sale at original prices. The Court determined that because the taxpayer provided no objective evidence of the reduced value of the excess inventory, the writedown was plainly inconsistent with the regulations, and the Commissioner properly disallowed it. 439 U.S. at 538. The Court considered that the taxpayer was, in effect, claiming a loss which it had not sustained, because the inventory was still available and had not been discarded. 439 U.S. at 545. Here, the

Commissioner is attempting to tax Molsen & Co. on income that it has not received. The Commissioner would recognize the increase in the value of the inventory, but he refuses to recognize the increase in the company's liabilities. In *Thor*, the Supreme Court found that there was a distortion in income when the taxpayer attempted to claim a loss not sustained; here, there would be a distortion of income if we adopted the Commissioner's position and taxed Molsen & Co. on income computed without taking into consideration the costs attributable to it.

In the final analysis, whether Molsen & Co.'s method of accounting for its unfixed, delivered, on-call purchases clearly reflects income is a question of fact. *St. James Sugar Co-op, Inc. v. United States*, 643 F.2d at 1223; *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. 521, 555 (1979), affd. 633 F.2d 512 (7th Cir. 1980). Based on the facts here present, we conclude that Molsen & Co.'s method clearly reflects its income and that the Commissioner was arbitrary and abused his discretion in seeking to change it.

The petitioners' position is strengthened by the following facts: (1) That Molsen & Co. used its method of accounting consistently in each of the years of its existence (see *Madison Gas & Electric Co. v. Commissioner*, 72 T.C. at 556; *Auburn Packing Co. v. Commissioner*, 60 T.C. at 799; *Sam W. Emerson Co. v. Commissioner*, 37 T.C. 1063, 1068 (1962)); (2) that its method conforms to an industry-wide practice of very long standing (see sec. 1.446–1(a)(2), Income Tax Regs.; *Garth v. Commissioner*, 56 T.C. at 619); and (3) that its method conforms to the best accounting practice in the industry (see *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 14–15 (1974), but see *Thor Power Tool Co. v. Commissioner, supra*). In addition, although Molsen & Co.'s accrual to purchases may not have met the all events test, on December 31, 1977, it was more than likely that the liabilities would become definitely fixed within a matter of months and that the liabilities would approximate the amount of the accrual. The market and the futures prices of cotton had risen by the end of the year, and while the market and the response thereto of the cotton sellers could not be predicted with complete accuracy, it was reasonable to assume that, in the event of a subsequent decline in the market, most of the sellers would call their contracts before their prices declined to the level of their provisional payments.

Moreover, the Commissioner's proposed treatment of unfixed, delivered, on-call purchases is inconsistent with his treatment of hedging transactions entered into by cotton merchants. A cotton merchant may hedge fixed price purchases and fixed price sales by entering into offsetting positions in the futures market. Hedging reduces the merchant's risk in the event of fluctuations in the market price of cotton. Hedging almost always involves taking a straddle position. As a result, the cotton merchant will normally make money on the actual cotton and lose money on the futures, or profit on the futures and lose (or receive less profit) on the actual cotton. See generally Willingham, "More than You Ever Wanted to Know About Hedging," 3 Agricultural L. J. 100–114 (1981–82). Gains and losses on hedging transactions receive ordinary income (or loss) treatment. See *Stewart Silk Corp. v. Commissioner*, 9 T.C. 174 (1947), and cases cited therein.

Since 1921, the Commissioner has expressly permitted cotton merchants, in determining gross income, to take into account gains and losses at the end of the taxable year based upon the market value of the open futures contracts to which they are parties as hedges against actual spot or cash transactions. A.R.M. 135, 5 C.B. 67 (1921), which is updated, restated, and superseded by Rev. Rul. 74–223, 1974–1 C.B. 23. The practice of bringing open futures contracts that are hedges to market at yearend is a part of the cotton merchants' larger accounting practice of bringing all elements of income to market at yearend:

> In the keeping of books in the cotton business, it has been the custom, existing over a period of approximately 100 years, for the cotton merchants to take into consideration at market his forward sales, purchases, and hedges, and if they show a profit, that is added to the season's business. If on the other hand, they show a loss, it is deducted from the season's business. His real profit, or loss, is hereby determined for the year. This system of bookkeeping is the only accurate and correct system that has been devised that truly reflects the net profit or loss of any given year's business, either fiscal or calendar. * * * [Rev. Rul. 74–223, *supra*, 1974–1 C.B. at 24.]

In permitting cotton merchants to bring their hedges to market at the end of the year, the Commissioner acknowledged that such practice was an exception to the "closed transaction" doctrine. A.R.M. 135, *supra*, 5 C.B. at 67.

In our opinion, an on-call purchase contract appears to function in much the same way as a hedge. For example, assume that a cotton merchant purchases 100 bales of cotton at a fixed price of 50 cents per pound, and at the same time, hedges the purchase by entering into a futures contract to deliver 100 bales of cotton at 55 cents per pound at a specified future date, for a combined theoretical profit of 5 cents on the actual and the futures transactions. In the event of a rise in the cotton market, the merchant's profit on the sale of the cotton will normally be offset by a loss on the closeout of the futures transaction. (Assuming that the market and futures prices move exactly in tandem, the merchant's 5 cents per pound profit is preserved.) In the event of a fall in the market, the loss on the sale of the cotton will be offset by the gain on the futures. An on-call purchase contract works in an analogous fashion. A rise in the market causes the company to recognize a profit on the sale of the cotton or an unrealized gain on the valuation of the cotton if it remains in inventory, but such profit or gain is offset in part by the accompanying increased liability for purchase cost under the on-call contract. Conversely, in a falling market, assuming that the provisional payment is not a guaranteed minimum price, the loss on the sale or inventory valuation of the cotton is offset by the company's reduced liability for purchase cost. We can perceive of no good reason why the Commissioner should allow cotton merchants to bring their hedging transactions to market at yearend and yet refuse to permit those same merchants to bring their unfixed, delivered, on-call purchases to market at yearend. Both practices are obviously a part of the cotton merchants' larger practice "of bringing all elements to market price at the end of the taxable year, which has been in use for a long period of years and which conforms to the best accounting practices in the trade, [and] is recognized as the only practical method of arriving at a true and correct result of the operations." Rev. Rul. 74-223, *supra*, 1974-1 C.B. at 24; see Rev. Rul. 74-227, 1974-1 C.B. at 121.

The petitioners also point out that the Commissioner's proposed treatment of on-call purchases is inconsistent with the cotton merchants' practice of bringing unfixed, delivered, on-call sales to market at the end of the year.[14] The Commissioner has taken no position with respect to such practice, but it is clearly another facet of the cotton merchants' general practice of bringing all open transactions to market. Some cotton merchants testified to their understandable concern that the Commissioner's approach to on-call purchases will distort the merchants' income if on-call sales are still to be brought to market: as the futures price of cotton changes, the merchants' on-call sales revenues increase or decrease inversely to the increase or decrease in the merchants' liabilities for on-call purchases; thus, if only on-call sales are brought to market, income will be overstated in a rising market and understated in a falling market. This is but another example of how the Commissioner's proposed change in the merchants' long-standing practice of accounting for on-call purchases will result in a distortion of their income. By altering a single aspect of the merchants' overall method of accounting for income, the Commissioner would change a method that clearly reflects income to one that does not.

Finally, the Commissioner has suggested that Molsen & Co.'s need to make a yearend accrual for unfixed, delivered, on-call purchases would not have arisen had the company adopted a taxable year based on its fiscal year and the cotton season. It is true that many cotton merchants usually have no delivered, on-call purchases remaining unfixed at the close of their taxable years because they have adopted years ending nearer the end of the cotton season on July 31. However, some cotton merchants testified that on-call purchases are occasionally based on October futures and that, consequently, it is possible for such purchases to be unfixed on July 31. Furthermore, there is absolutely no evidence that Molsen & Co. is attempting to manipulate its tax liability by employing a taxable year based on the calendar year. The company has employed its December 31 tax year since its founding as a partnership over 50 years ago. Conceivably, a calendar year was adopted to conform to the taxable years of the partners of the closely held business.

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[14] Although Molsen & Co. rarely has unfixed, delivered, on-call sales at the close of its taxable year (because the company, as a rule, requires its buyers to call the price before it will deliver the cotton), several other cotton merchants testified that their firms have delivered, on-call sales remaining unfixed at yearend that are brought to market for tax purposes.

The second issue for decision is whether the petitioners are entitled to an award of costs and attorneys' fees. This Court is without authority to award costs or attorneys' fees unless specifically authorized to do so by act of Congress. See *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240 (1975); *Sharon v. Commissioner*, 66 T.C. 515 (1976), affd. 591 F.2d 1273 (9th Cir. 1978). The petitioners contend that they are entitled to costs and attorneys' fees pursuant to 28 U.S.C. section 2412 (1982 ed.), as amended by the Equal Access to Justice Act, Pub. L. 96-481, title II, sec. 204(a), 94 Stat. 2327 (effective Oct. 1, 1981).[15]

By virtue of 28 U.S.C. section 451 (1981 ed.),[16] section 2412 of tit. 28 applies only to courts established under article III of the United States Constitution, that is, courts "the judges of which are entitled to hold office during good behavior." *McQuiston v. Commissioner*, 78 T.C. 807, 811 (1982), affd. without published opinion 711 F.2d 1064 (9th Cir. 1983); *Sharon v. Commissioner*,

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[15] Sec. 2412 of tit. 28, as in effect when the petitioners commenced these cases, provided in pertinent part as follows:

Sec. 2412. Costs and Fees

(a) Except as otherwise specifically provided by statute, a judgment for costs, as enumerated in section 1920 of this title, but not including the fees and expenses of attorneys, may be awarded to the prevailing party in any civil action brought by or against the United States or any agency and any official of the United States acting in his or her official capacity in any court having jurisdiction of such action. A judgment for costs when taxed against the United States shall, in an amount established by statute, court rule, or order, be limited to reimbursing in whole or in part the prevailing party for the costs incurred by such party in the litigation.

(b) Unless expressly prohibited by statute, a court may award reasonable fees and expenses of attorneys, in addition to the costs which may be awarded pursuant to subsection (a), to the prevailing party in any civil action brought by or against the United States or any agency and any official of the United States acting in his or her official capacity in any court having jurisdiction of such action. The United States shall be liable for such fees and expenses to the same extent that any other party would be liable under the common law or under the terms of any statute which specifically provides for such an award.

* * * * * * *

(d)(1)(A) Except as otherwise specifically provided by statute, a court shall award to a prevailing party other than the United States fees and other expenses, in addition to any costs awarded pursuant to subsection (a), incurred by that party in any civil action (other than cases sounding in tort) brought by or against the United States in any court having jurisdiction of that action, unless the court finds that the position of the United States was substantially justified or that special circumstances make an award unjust.

[16] Sec. 451 of tit. 28 provides in pertinent part as follows:

Sec. 451. Definitions

As used in this title:

The term "court of the United States" includes the Supreme Court of the United States, courts of appeals, district courts constituted by chapter 5 of this title, including the Court of Claims, the Court of Customs and Patent Appeals, Court of International Trade and any court created by Act of Congress the judges of which are entitled to hold office during good behavior.

66 T.C. at 534. It does not apply to the Tax Court, an article I court, whose judges serve for a term of 15 years after taking office. Secs. 7441, 7443(e); *Bowen v. Commissioner*, 706 F.2d 1087 (11th Cir. 1983), affg. per curiam 78 T.C. 55 (1982); *McQuiston v. Commissioner*, 78 T.C. at 811. Therefore, we have no authority to grant costs or attorneys' fees to the petitioners under section 2412 of title 28. We observe that taxpayers prevailing in the Tax Court may now recover reasonable litigation costs, including attorneys' fees, pursuant to section 7430 of the Code,[17] but such section is only applicable to proceedings commenced after February 28, 1983, and before January 1, 1986. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, sec. 292(a), (e), 96 Stat. 572, 574 (1982). A case is commenced in this Court by the filing of a petition. Rule 20(a), Tax Court Rules of Practice and Procedure. Since the petitioners filed their petitions in these cases on September 10, 1982, we are unable to award them costs or attorneys' fees under section 7430.

Decisions will be entered for the petitioners.

JULES REINHARDT AND MARILYN D. REINHARDT, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 14506-83. Filed September 30, 1985.

P was a physician and a shareholder-employee of C, a professional corporation that renders medical care and treatment through duly licensed physicians. As such, P was covered by C's qualified profit-sharing and pension plans that were available only to physicians who were shareholder-employees. P sold his C stock, divested himself of all his economic interests related to C, and terminated his employee relationship with C. Shortly thereafter, P entered into an independent contractor relationship with C and continued to provide the same services as a physician. Upon terminating his employee relationship, P received a distribution from C's qualified plans. *Held*: P's change in employment status from that of an employee to that of an independent contractor did not constitute a "separation from the service" within the meaning of sec. 402(e)(4)(A)(iii), I.R.C. 1954. Therefore, the distribution to P was not a lump-sum distribution, and P is not entitled to use the 10-year averaging method provided by sec. 402(e)(1) in determining the tax on that distribution.

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[17] Sec. 7430 provides in pertinent part as follows:

> SEC. 7430(a). IN GENERAL.—In the case of any civil proceeding which is—
>
> (1) brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, and
>
> (2) brought in a court of the United States (including the Tax Court and the United States Claims Court),
>
> the prevailing party may be awarded a judgment for reasonable litigation costs incurred in such proceeding.

Gregory K. Wise, for the petitioners.
Timothy S. Murphy, for the respondent.

OPINION

PARKER, *Judge*: Respondent determined a deficiency in petitioners' 1979 Federal income tax in the amount of $43,671. The issue for decision is whether petitioners properly reported a distribution from qualified profit-sharing and pension plans under the 10-year averaging method provided by section 402(e)(1).[1] Resolution of this issue depends on whether petitioner Jules Reinhardt's change of employment status from that of employee to that of independent contractor was a "separation from the service" within the meaning of section 402(e)(4)(A)(iii), even though he continued to perform exactly the same services as a physician after the change.

This case was submitted fully stipulated. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.

Petitioners Jules Reinhardt and Marilyn D. Reinhardt resided in Lapeer, Michigan, at the time the petition was filed in this case. Petitioners timely filed their 1979 joint Federal income tax return (Form 1040) with the Internal Revenue Service Center in Covington, Kentucky. Petitioner Marilyn D. Reinhardt is a party in this case solely because she filed a joint tax return with her husband for the year in issue. All references to petitioner in the singular will be to petitioner Jules Reinhardt.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable year in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

Knollwood Clinic (the clinic) is a Professional Corporation (P.C.) organized under the laws of the State of Michigan. The Clinic renders medical care and treatment through duly licensed physicians. All physicians at the clinic practice medicine under either a standard association agreement or a standard employment agreement. Physicians who practice under association agreements are independent contractors, and physicians who practice under employment agreements are employees of the clinic. Only those physicians who are shareholders in the clinic are eligible to practice at the clinic under employment agreements and thus eligible to participate in the clinic's pension and profit-sharing plans. Except for eligibility in the clinic's pension and profit-sharing plans, the other fringe benefits provided by the clinic are essentially the same for all physicians regardless of their employment arrangement.[2]

Consistent with the clinic's employment policy, petitioner and the clinic executed a 1-year, renewable employment agreement on July 1, 1978. From that date until June 30, 1979, petitioner was a practicing physician and a shareholder-employee of the clinic. Petitioner also served as an officer and director of the clinic. The clinic paid petitioner a salary pursuant to the employment agreement and properly deducted and withheld the appropriate Federal, State, and local taxes from petitioner's wages. Petitioner's employment agreement was identical in all material respects to other employment agreements between the clinic and other employee-physicians. As a shareholder-employee, petitioner was eligible to participate and did participate in the clinic's pension and profit-sharing plans.

Petitioner had other economic interests indirectly related to the operations of the clinic. Petitioner held stock in Doc Development, a corporation that owns the building in which the clinic is located. Petitioner also held stock in Lapeer Apothecary, a corporation that operates the pharmacy associated with the clinic.

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[2] The employment agreement provides coverage for group term life insurance, but the association agreement does not provide such coverage.

Petitioner desired to establish his own office in the Lapeer area. Petitioner first explored the possibility of establishing his own office in the Lapeer County area on or about January 1, 1979. Petitioner terminated his employment agreement[3] with the clinic on June 30, 1979, in anticipation of establishing his own office in the area. However, pursuant to paragraph 14 of petitioner's employment agreement, petitioner was prohibited from practicing medicine within a 12-mile radius of the clinic for 90 days from the date of termination. Violation of this noncompetition provision would have obligated petitioner to pay the clinic liquidated damages in the amount of $10,000.

On or before the date petitioner terminated his employment agreement with the clinic, petitioner divested himself of all of his economic interests related to the clinic. On June 30, 1979, petitioner sold all of his stock in the clinic and all of his stock in Doc Development, the corporation that owns the clinic's building.[4] In addition, prior to July 1, 1979, petitioner resigned as officer and director of the clinic. As of July 1, 1979, petitioner's only interest in the clinic was that of a creditor for the balance due for the sale of his stock.

While making arrangements to open his own office, petitioner needed a source of income and needed facilities to continue caring for his patients. If he wanted to practice within a 12-mile area of the clinic, petitioner's only option, other than paying the $10,000 in liquidated damages, was to enter into an association agreement with the clinic. Since petitioner was no longer a shareholder of the clinic, petitioner was not eligible to enter into an employment agreement with the clinic. Consequently, on July 2, 1979, petitioner entered into an association agreement with the clinic for a 5-year term. Thereafter, petitioner served the clinic as an independent contractor. The clinic treated petitioner as an independent contractor and paid petitioner fees for performing services. The clinic no longer deducted withholding taxes, and petitioner was given a Form 1099 to report these fees. Petitioner's association agreement with the clinic was identical in all material respects to the agreements between the clinic and all of its other nonemployee physicians. For Federal employment tax purposes, the clinic treated petitioner as an employee during the first half of 1979 and as an independent contractor during the second half. However, petitioner rendered the same services as a physician under the association agreement as he had previously rendered under the employment agreement.

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[3] Par. 12 of petitioner's employment agreement required 6 months' written notice prior to termination. Petitioners did not submit any evidence that notice was timely given pursuant to the terms of the agreement.

[4] On Jan. 31, 1978, petitioner had sold all of his stock in Lapeer Apothecary, the corporation that operates the pharmacy associated with the clinic.

On January 20, 1981, petitioner was one of the incorporators of Metamora Medical, P.C. Pursuant to his association agreement with the clinic, petitioner gave the clinic a 6-month notice of termination. After terminating his association agreement, petitioner waited 90 days to begin practicing medicine at Metamora Medical, P.C., to avoid the $10,000 liquidated damages provision in the association agreement.[5] As of April 1, 1981, petitioner had severed all relations with the clinic and was a full-time employee of Metamora Medical, P.C.

After petitioner terminated his employment agreement with the clinic on June 30, 1979, petitioner received a distribution in July of 1979 from the clinic's pension and profit-sharing plans in the amount of $150,744. He reported the distribution on his 1979 return using the special 10-year averaging provision for determining the tax on that distribution. Petitioner did not deduct any auto expenses on his return.[6]

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[5] This noncompetition provision was essentially identical to the noncompetition provision in the employment agreement.

[6] The petition raises an argument that the Commissioner erred in determining that $2,750 of auto expenses was a deduction against personal service income for purposes of computing the 50-percent maximum rate on personal service income under sec. 1348. The parties stipulated that petitioner Jules Reinhardt deducted no automobile expenses on his 1979 return and that that return, as previously adjusted by respondent and agreed to by petitioners, did not allow any deduction for automobile expense. Petitioners make just a passing reference to this argument on brief. Respondent did not mention the issue in his opening brief and elected not to file a reply brief.

We do not wholly understand petitioners' argument. Petitioners' original return did not include the $2,750 in the computation of the maximum tax, but we do not understand petitioners to suggest that the item does not constitute personal service income. In recomputing petitioners' 1979 tax under sec. 1348 (which was the lowest of the three computations and hence the one used to determine petitioners' tax liability), respondent included reimbursed automobile expenses in the amount of $2,750 as personal service income. However, respondent allowed the same item as a deduction against petitioners' personal service income, creating a wash. Petitioners seem to argue that otherwise properly deductible expenses under sec. 1348 should be deducted only to the extent such expenses are allowed as deductions for the regular tax computation. Petitioners conclude that because they were not allowed a deduction for automobile expenses on their return, these expenses are not properly deducted under sec. 1348. However, if the deduction were not allowed, it would increase the amount of petitioners' tax liability, since reimbursed automobile expense is properly includable in income.

While we do not see how it helps petitioners, they may be drawing a distinction between a

By statutory notice of deficiency dated March 24, 1983, respondent determined that the distribution petitioner received from the clinic's qualified profit-sharing and pension plans did not qualify for the special 10-year averaging method provided by section 402(e)(1) because petitioner had not "separated from the service" of his employer within the meaning of section 402(e)(4)(A)(iii). This lawsuit ensued.

Petitioner argues that the termination of his employment agreement with the clinic on June 30, 1979, constituted a "separation from the service" of the clinic as of July 1, 1979.[7] Petitioner further argues that the distribution on account of that separation from the service was properly reported on his 1979 return using the special 10-year averaging method provided by section 402(e)(1). We must decide whether the termination of petitioner's employment agreement amounted to a "separation from the service" within the meaning of section 402(e)(4)(A)(iii).

Generally, distributions made from a qualified pension or profit-sharing plan are taxable to the recipient as ordinary

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deduction "allowed" and one "allowable." Sec. 1348(b)(2) provides in part that the term personal service net income means personal service income reduced by any deductions *allowable* under sec. 62 which are properly allocable to or chargeable against such personal service income. Whether the automobile expenses were *allowed* as a deduction on petitioners' return is not determinative of whether such expenses are allowable as a deduction under sec. 1348. See, for example, sec. 1016(a)(2) and sec. 1.1016–3(a)(1)(i), Income Tax Regs., regarding the definitional difference between allowed and allowable. Petitioners do not claim nor did they submit any evidence indicating that the automobile expenses were not allowable under sec. 62 or not properly allocable or chargeable to personal service income. The facts of this case were fully stipulated, but that does not alter the burden of proof which still rests with petitioners. *Service Bolt & Nut Co. Trust v. Commissioner*, 78 T.C. 812, 819 (1982), affd. on other issues 724 F.2d 519 (6th Cir. 1983); *Estate of Luehrmann v. Commissioner*, 33 T.C. 277, 281 (1959), affd. 287 F.2d 10, 16 (8th Cir. 1961); *Stevens v. Commissioner*, T.C. Memo. 1980–521. Thus, we hold that petitioners failed to prove that respondent erroneously deducted automobile expenses in the amount of $2,750 in computing petitioners' tax under sec. 1348.

[7] Petitioner does not argue that the termination of his *association agreement* in January of 1981 constituted his "separation from the service" on account of which he received the distribution. See sec. 402(e)(4)(A)(iii). We note that we do not read the phrase "on account of" to require strict coincidence in time of the date upon which the right to the distribution accrues and the date of separation. *Gittens v. Commissioner*, 49 T.C. 419, 423 (1968). Cf. *E.N. Funkhouser v. Commissioner*, 44 T.C. 178, 185 (1965), affd. 375 F.2d 1 (4th Cir. 1967). See also *Smith v. United States*, 460 F.2d 1005, 1016 (6th Cir. 1972), where the Sixth Circuit stated "The only time limitation in the statute requires that the total distributions payable to any employee be paid within one taxable year of the distributee so long as the payment shall be made on account of the separation from the service, and there is no requirement that the separation from the service occur before the distribution occurs or that both events must occur within the same year." Here the stipulated facts clearly show that the distribution to petitioner was made "on account of" the termination of his employment agreement on June 30, 1979, and petitioner does not suggest otherwise.

income under section 72 (relating to annuities). Sec. 402(a)(1).[8] However, Congress has accorded preferential tax treatment for reporting distributions where the recipient receives his entire interest from a qualified plan in a lump-sum distribution. Section 402(a)(2) allows capital gains treatment for lump-sum distributions attributable to pre-1974 active participation in a qualified employee trust.[9] Section 402(e)(1) provides a special 10-year averaging method for reporting the ordinary income portion of a lump-sum distribution.[10] The term "lump-sum distribution," as defined in section 402(e)(4)(A), means a distribution from a qualified trust within 1 taxable year of the recipient which becomes payable to the recipient "on account of" the employee's death, disability, attaining age 59½, or separation from the service.[11] The phrase "separation from the service" is not defined in the Code or regulations. Consequently, the courts have looked to the language of the statute and its legislative history in construing the phrase so as to give effect to the intent of Congress. *United States v. American Trucking Associations, Inc.*, 310 U.S. 534, 542–545 (1940), rehearing denied 311 U.S. 724.

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[8] Sec. 402(a)(1) provides as follows:

SEC. 402(a). Taxability of Beneficiary of Exempt Trust.—

(1) General rule.—Except as provided in paragraphs (2) and (4), the amount actually distributed or made available to any distributee by any employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be taxable to him, in the year in which so distributed or made available, under section 72 (relating to annuities). The amount actually distributed or made available to any distributee shall not include net unrealized appreciation in securities of the employer corporation attributable to the amount contributed by the employee. Such net unrealized appreciation and the resulting adjustments to basis of such securities shall be determined in accordance with regulations prescribed by the Secretary.

[9] Sec. 402(a)(2) provides in pertinent part:

(2) Capital gains treatment for portion of lump sum distribution.—In the case of an employee trust described in section 401(a), which is exempt from tax under section 501(a), so much of the total taxable amount (as defined in subparagraph (D) of subsection (e)(4)) of a lump sum distribution as is equal to the product of such total taxable amount multiplied by a fraction—

(A) the numerator of which is the number of calendar years of active participation by the employee in such plan before January 1, 1974, and

(B) the denominator of which is the number of calendar years of active participation by the employee in such plan,

shall be treated as a gain from the sale or exchange of a capital asset held for more than [appropriate holding period] * * *

[10] Sec. 402(e)(1) provides that:

SEC. 402(e). Tax on Lump Sum Distributions.—

(1) Imposition of separate tax on lump sum distributions.—

(A) Separate tax.—There is hereby imposed a tax (in the amount determined under subparagraph (B)) on the ordinary income portion of a lump sum distribution.

(B) Amount of tax.—The amount of tax imposed by subparagraph (A) for any taxable year shall be an amount equal to the amount of the initial separate tax for such taxable year multiplied by a fraction, the numerator of which is the ordinary income portion of the lump sum distribution for the taxable year and the denominator of which is the total taxable amount of such distribution for such year.

(C) Initial separate tax.—The initial separate tax for any taxable year is an amount equal to 10 times the tax which would be imposed by subsection (c) of section 1 if the recipient were an individual referred to in such subsection and the taxable income were an amount equal to $2,300 plus one-tenth of the excess of—

(i) the total taxable amount of the lump sum distribution for the taxable year, over

(ii) the minimum distribution allowance.

(D) Minimum distribution allowance.—For purposes of this paragraph, the minimum distribution allowance for the taxable year is an amount equal to—

(i) the lesser of $10,000 or one-half of the total taxable amount of the lump sum distribution for the taxable year, reduced (but not below zero) by

(ii) 20 percent of the amount (if any) by which such total taxable amount exceeds $20,000.

(E) Liability for tax.—The recipient shall be liable for the tax imposed by this paragraph.

The phrase "separation from the service" first appeared in the Code in 1942 when Congress enacted a provision allowing capital gains treatment for total distributions on account of the employee's death or other separation from the service.[12] The accompanying committee report stated that a "separation from the service" occurs when the employee retires or *severs his connection with his employer*. S. Rept. 1631, 77th Cong., 2d Sess. (1942), 1942–2 C.B. 504, 607.[13]

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[11] Sec. 402(e)(4)(A) provides in pertinent part:

(4) DEFINITIONS AND SPECIAL RULES.—

(A) LUMP SUM DISTRIBUTION.—For purposes of this section and section 403, the term "lump sum distribution" means the distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient—

(i) on account of the employee's death,

(ii) after the employee attains age 59½

(iii) on account of the employee's separation from the service, or

(iv) after the employee has become disabled (within the meaning of section 72(m)(7))

from a trust which forms a part of a plan described in section 401(a) and which is exempt from tax under section 501 * * *

[12] The amendment to sec. 165 of the 1939 Code was enacted by sec. 162(a) of the Revenue Act of 1942, 56 Stat. 862. Sec. 165(b) stated in pertinent part:

SEC. 165. Employees' Trusts.

(b) TAXABILITY OF BENEFICIARY.—The amount actually distributed or made available to any distributee by any such trust shall be taxable to him, in the year in which so distributed or made available, under section 22(b)(2) as if it were an annuity the consideration for which is the amount contributed by the employee, except that if the total distributions payable with respect to any employee are paid to the distributee within one taxable year of the distributee *on account of the employee's separation from the service*, the amount of such distribution to the extent exceeding the amounts contributed by the employee, shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months. [Emphasis added.]

[13] The Senate report provides in pertinent part:

"The provisions of the House bill with respect to section 165(b), concerning the taxation of the beneficiary of a trust which meets the requirements of section 165(a), have not been changed except to take care of the situation where an employee receives the total distributions that he is entitled to under the plan in one taxable year *on account of his separation from the service*. In such a case, it is provided that the amount of such distributions to the extent that it exceeds the

In 1954, Congress replaced section 165(b) with section 402(a)(2) retaining the provision for capital gains treatment for lump-sum distributions from qualified trusts on account of the employee's death or other separation from the service.[14] In 1974, the phrase "separation from the service" was moved from section 402(a)(2) to section 402(e)(4)(A)(iii) and is now part of the definition of lump-sum distribution. Section 2005 of the Employment Retirement Income Security Act of 1974 (ERISA), Pub. L. 93–406, 88 Stat. 829, 1974–3 C.B. 156. See note 11 *supra*.

Relying on the language in the legislative history, this Court has consistently interpreted "separation from the service" to mean when an employee severs his connection with his employer. *Bolden v. Commissioner*, 39 T.C. 829 (1963); *Estate of Rieben v. Commissioner*, 32 T.C. 1205 (1959); *Oliphint v. Commissioner*, 24 T.C. 744 (1955), affd. on another point 234 F.2d 699 (5th Cir. 1956); *Estate of Fry v. Commissioner*, 19 T.C. 461 (1952), affd. per curiam 205 F.2d 517 (3d Cir. 1953); *Glinske v. Commissioner*, 17 T.C. 562 (1951). We note that the more recent court decisions construing "separation from the service" have involved distributions incident to corporate mergers, reorganizations, or complete liquidations where the employee, after receiving the distribution, continued employment for the employer that survived the reorganization, merger, or liquidation. We have taken the position that "separation from the service" occurs in this context only if the corporate reorganization, merger, or liquidation results in a substantial change in the makeup of employees. *Gittens v. Commissioner*, 49 T.C. 419, 424 (1968), adopting the interpretation of the Fifth

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amounts contributed by the employee shall be considered a gain from the sale or exchange of a capital asset held for more than six months. For example, if under a profit-sharing trust, the total distributions to which an employee is entitled are paid to the employee in the year in which he retires or *severs his connection with his employer*, or to his widow if he dies during the course of his employment, the amount received by the employee or widow to the extent it exceeds the employee's contributions will be considered a gain from the sale or exchange of a capital asset held for more than six months. [Emphasis added.]"

[14] As originally adopted in 1954, sec. 402(a)(2), I.R.C. 1954, provided in pertinent part:

> CAPITAL GAINS TREATMENT FOR CERTAIN DISTRIBUTIONS.—In the case of an employees' trust described in section 401(a), which is exempt from tax under section 501(a), if the total distributions payable with respect to any employee are paid to the distributee within 1 taxable year of the distributee on account of *the employee's death or other separation from the service*, or on account of the death of the employee after his separation from the service, the amount of such distribution. * * * shall be considered a gain from the sale or exchange of a capital asset held for more than 6 months * * *

Circuit in *United States v. Johnson*, 331 F.2d 943 (5th Cir. 1964); *Gegax v. Commissioner*, 73 T.C. 329, 334 (1979). Compare *Smith v. United States*, 460 F.2d 1005, 1014–1015 (6th Cir. 1972). While this Court has never considered a fact situation precisely like the present case, we have consistently followed as a general guideline that separation from the service "requires a change in the employment relationship in more than a formal or technical sense." *Gittens v. Commissioner*, *supra*, 49 T.C. at 424. It is against this legislative history and these judicial precedents that we consider the present case.

Petitioner argues that the change in his employment status with the clinic from that of an employee to that of an independent contractor was a separation from the service within the meaning of section 402(e)(4)(A)(iii) even though he continued to perform the same services as a physician for the clinic after the change as he had performed before the change. Respondent disagrees. Respondent's position in this case is similar to the position taken in Rev. Rul. 81–26, 1981–1 C.B. 200. In that revenue ruling, the Commissioner ruled that the change of employment status from that of a common law employee to that of a partner was not a "separation from the service" within the meaning of section 402(e)(4)(A)(iii) because the employee did not retire or resign; nor was the employee discharged, but instead continued to render services in the ongoing business. Rev. Rul. 81–26, 1981–1 C.B. 200, 201, superseding Rev. Rul. 73–414, 1973–2 C.B. 144.

A revenue ruling of course merely represents the position of one of the litigants in this case, the Commissioner of Internal Revenue, and does not necessarily even represent the view of the Treasury Department. *Crow v. Commissioner*, 85 T.C. 376 (1985). As such, revenue rulings are not binding on either the Treasury Department or the courts. *Stubbs, Overbeck & Associates v. United States*, 445 F.2d 1142, 1146–1147 (5th Cir. 1971). However, revenue rulings may be helpful in interpreting a statute and may be considered on their own intrinsic merit and persuasiveness or lack thereof.

The parties have not cited and we have not found any case precisely like the instant case. The most analogous factual situation is one involving an employee in an accounting firm who was promoted to partner, and in that case the Claims

Court reached the same result as in Rev. Rul. 81–26, *supra*. *Ridenour v. United States*, 3 Cl. Ct. 128 (1983).

In *Ridenour*, the taxpayer was promoted from employee (or associate) to partner in a public accounting firm. The firm's profit-sharing plan provided that participants who became partners in the firm were no longer eligible to participate in the plan and that all amounts credited and vested to their accounts had to be distributed to them within 60 days after the end of the taxable year in which they became partners. Upon becoming a partner, the taxpayer received a distribution from the plan and argued that the distribution qualified for preferential tax treatment—capital gains treatment for pre-1974 amounts and 10-year averaging for the balance. In support of such treatment, the taxpayer contended that his distribution from the plan was a lump-sum distribution as defined in section 402(e)(4)(A) because it was made on account of his separation from the service. Recognizing that this was an issue of first impression, the Claims Court carefully reviewed the framework of the Code's retirement plan provisions, their legislative histories, and relevant administrative and judicial decisions. The Claims Court concluded that a common law employee's promotion to partner, by and of itself, does not constitute a "separation from the service" under section 402(e)(4)(A)(iii) and that, a fortiori, such a promotion from associate to partner of the firm does not. *Ridenour v. United States*, 3 Cl. Ct. at 139. Without retracing all of the ground traversed by the Claims Court's well-reasoned opinion, we agree with the analysis and the conclusion reached.

The taxpayer in *Ridenour* based his argument on the distinction between the common law meaning of employee and the self-employed, suggesting that "service" refers only to tasks an employee performs for his employer. The taxpayer asserted that the phrase "separation from the service" should be construed to include the termination of the common law employment relationship, such as when an employee is promoted to partner, because partners join together in carrying on a trade or business or profession. In dismissing this argument, the Claims Court stated "Common-law distinctions should not govern statutory interpretations if they would frustrate the objectives which pension legislation is designed to serve." *Ridenour v. United States*, 3 Cl. Ct. at 131, citing

Moragne v. States Marine Lines, 398 U.S. 375 (1970); *United States v. Silk*, 331 U.S. 704 (1947); and *NLRB v. Hearst Publications*, 322 U.S. 111 (1944). After an exhaustive review of the legislative history,[15] the Claims Court, in *Ridenour*, generally concluded that the distinction to be drawn is between one who continues to provide services and one who discontinues providing services, rather than upon the particular status of the person rendering the services. The Claims Court concluded that one who continues to provide services has not separated from the service within the meaning of section 402(e)(4)(A)(iii). In the instant case, petitioner presents an argument similar to that in *Ridenour* to support his position, and we find it equally unpersuasive.

Petitioner also appears to construe "separation from the service" as meaning simply a change in one's employment status for purposes of Federal employment taxes imposed by subtitle C of the Code. Petitioner submitted a letter from the Internal Revenue Service, dated August 28, 1981, which acknowledges that for purposes of the Federal employment tax provisions, the Service recognizes that nonshareholder physicians practicing at the clinic do not hold substantially similar positions as the employee physicians.[16] Petitioner contends that this letter supports his argument that becoming an independent contractor for Federal employment tax purposes, together with divesting himself of all economic interests related to the clinic, amounts to a "separation from the service" even though he continued to provide the same services for the clinic before and after his change in employment status. That letter from the Internal Revenue Service related to special relief provided to employers by section 530 of the Revenue Act of 1978.[17] That special provision granted interim relief for employers involved in certain employment tax status controversies, by prohibiting the Internal Revenue Service for a period of time from applying any changed position or newly stated position or from reclassifying certain individuals as employees for purposes of Federal income tax withholding. S. Rept. 95–1263 (1978), 1978–3 C.B. (Vol. 1) 315, 508. That narrow, specific relief provision for employers has nothing to do with the issue before the Court.

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[15] See also *United States v. Johnson*, 331 F.2d 943 (5th Cir. 1964), and *Gittens v. Commissioner*, 49 T.C. 419 (1968), where this Court and the Fifth Circuit also traversed this same ground.

[16] Dr. Paul D. Lepor from the clinic requested United States Representative Bob Traxler to intercede on the clinic's behalf during an examination of the clinic by the Internal Revenue Service. This letter was in reply to Mr. Traxler's letter dated July 29, 1981, which is not part of the record. The letter provides in pertinent part:

"In the course of an audit the question of the employment tax status of non-shareholder doctors performing services for the Clinic was raised. As you are aware, section 530 of the Revenue Act of 1978 prevents the Service from assessing any employment tax liabilities with respect to these workers if certain conditions are met. Section 530 relief generally applies if the taxpayer did not treat an individual as an employee in the past and has a reasonable basis for not treating the individual as an employee. Under section 530(a)(3) of the Act, for years after 1978, the relief applies only if the appropriate federal tax returns are filed by the taxpayer consistent with the taxpayer's treatment of the individual as not being an employee, and only if the taxpayer has not, after 1977, treated any individual holding a substantially similar position as an employee.

"The Clinic has continuously treated its shareholder doctors as employees. Therefore, under section 530(a)(3) of the Act, the Clinic would not be entitled to section 530 relief, if the nonshareholder doctors hold *substantially* similar positions as the shareholder doctors. In applying section 530(a)(3) to the Clinic, the Service considered the Congressional intent (as expressed in the pertinent Committee Reports) that section 530 relief be granted liberally. After careful deliberation, the Clinic has been granted relief under section 530."

As in *Ridenour*, petitioner also cites Rev. Rul. 69–647, 1969–2 C.B. 100, to support his position. In Rev. Rul. 69–647, the Commissioner ruled that an employee who retired from full-time employment but continued to provide advisory opinions on an irregular basis to his former employer as an independent contractor, separated from the service upon his retirement from full-time service. Rev. Rul. 69–647, 1969–2 C.B. at 101. The ruling also determined that since the employer no longer had the right to exercise the direction and control necessary under the common law rules to establish an employer-employee relationship, such relationship did not exist for Federal employment tax purposes and the amounts paid to the taxpayer were not wages for withholding purposes. Rev. Rul. 69–647, 1969–2 C.B. at 101. Petitioner argues that the determinative factor for finding a separation from the service in Rev. Rul. 69–647 was the taxpayer's change in employment status for Federal employment tax purposes. We disagree. The change in employment status from employee to independent contractor was not controlling in Rev. Rul. 69–647, nor is it here.[18] See *Ridenour v. United States*, *supra*, 3 Cl. Ct. at 137, where that court stated:

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[17] Sec. 530 of the Revenue Act of 1978, Pub.L. 95–600, 92 Stat. 2885.

[18] We note that respondent's revenue rulings on the matter of "separation from the service" under sec. 402 and its predecessors have been confusing, ambiguous, conflicting, and of little assistance to the courts in deciding cases arising thereunder. See *United States v. Johnson*, 331 F.2d at 949–951; *United States v. Haggart*, 410 F.2d 449, 453 (8th Cir. 1969); *United States v. Martin*, 337 F.2d 171, 175–176 (8th Cir. 1964). We do not find Rev. Rul. 69–647 intrinsically persuasive, and we agree with the Claims Court that it is distinguishable on its facts in any event.

> Although, in this ruling, the Internal Revenue Service considered the common-law status as a factor, the key element in determining whether there had been a "separation from the service" was the fact that the employer was not exercising supervision over the taxpayer, nor requiring his compliance with detailed orders or instructions. In addition, there was no established work schedule, nor was it necessary for the employee to obtain the employer's permission to be absent from work. In other words, the employee was not obligated to work and only a minimal obligation to provide services existed.

Petitioner further attempts to distinguish *Ridenour* by contending that he has not received a promotion as the taxpayer in *Ridenour* received, but if anything, has taken a decrease in a true economic sense. Petitioner asserts that as an independent contractor, he earned considerably less than he earned as an employee. In addition, petitioner contends the profit-sharing plan in *Ridenour* could have provided for partners to continue their participation, but the clinic's pension and profit-sharing plans could not have so provided because nonemployees may not participate in corporate plans. Both of these distinctions are irrelevant or at best tenuous. Here, petitioner chose to sell his stock in the clinic, to terminate his employment agreement, and to precipitate the lump-sum distribution made to him while he remained with the clinic and continued to render services to the clinic under an association agreement. In *Ridenour*, the Claims Court based its decision on the fact that the taxpayer continued to provide services to his employer after the change in his employment status. We think that factor is determinative and should also control the result in this case.

This Court has previously determined that "separation from the service" does not occur unless the employee severs his connection with his employer. *Bolden v. Commissioner, supra; Estate of Fry v. Commissioner, supra*. Separation from the service requires a change in the employment relationship in more than a formal or technical sense. *Gittens v. Commissioner, supra*.

Whether an employee has severed his connection with his employer is a question of fact. In *Bolden v. Commissioner, supra*, an owner-employee who sold his business had not separated from the service because he contracted with the new owner to continue to advise the business. In addition, an employee who retired from service and no longer performed services for his employer but continued to receive his full salary had not severed his connection with his employer. *Estate of Fry v. Commissioner, supra.*

In the instant case, petitioner terminated his employment agreement with the clinic on June 30, 1979, and executed an association agreement with the clinic on July 2, 1979. The services rendered by petitioner as a physician for the clinic did not change as a result of the change in petitioner's employment status. In fact, both his employment and his association agreement required petitioner to perform services at the clinic on a full-time basis. Moreover, nothing in the record indicates that petitioner's duties or responsibilities as a physician at the clinic diminished one iota as a result of becoming an independent contractor.

On the facts presented, we think it is clear that petitioner did not sever his connection with the clinic within the meaning of section 402(e)(4)(A)(iii) when he terminated his employment agreement on June 30, 1979, and entered into an association agreement with the clinic on July 2, 1979.

To treat such a technical change in employment status as a separation from the service would, in our opinion, contravene the congressional policy behind section 402(e)(4)(A) and its predecessors. Congress was not trying just to alleviate the effects of bunching of income whenever an employee receives a lump-sum distribution from a qualified plan *for any reason*. The congressional policy was more narrowly aimed at discouraging early distributions before retirement age and yet preserving portability of pension funds when an employee actually separates from the service of his employer before retirement age. Hence, the favorable tax treatment does not apply when qualified pension and profit-sharing plans are terminated because that could encourage abuses of early distributions unrelated to retirement purposes;[19] the favorable tax treatment applies to distributions narrowly restricted to situations where the employee, before retirement age, completely severs his connection with his employer as a result of death, disability, attaining age 59½ (usually for the self-employed), or separation from the service. See *Jennemann v. Commissioner*,

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[19] Of course, a distribution upon plan termination may be a "qualifying rollover distribution" under sec. 402(a)(5)(D), and be rolled over into another qualifying plan.

67 T.C. 906, 910 (1977);[20] *Ridenour v. United States*, 3 Cl. Ct. at 136–137; H. Rept. 93–1280 (Conf.) (1974), 1974–3 C.B. 415, 510. As H. Rept. 93–1280 shows, Congress sought to treat the employee and the self-employed person (independent contractor, partner, etc.) the same, not differently. Favorable tax treatment for a distribution made on account of a true separation from the service fosters the congressional policy to protect the mobility of our work force, and to provide portability of pension funds. Where, as here, the individual continues to render services to the same business, there is no justification for the preferential tax treatment. A lump-sum distribution in that situation is not related to retirement purposes and could result in abusive situations where pension funds are bailed out prematurely, not for retirement purposes, but for investments, starting a new business, or whatever other personal reason the employee might have for wanting to get his money out of the pension plan through an early distribution. To permit preferential tax treatment in that situation would, in our opinion, be contrary to the restrictive statutory language of section 402(e)(4)(A), and contrary to the policy considerations underlying the statute.

Petitioner's change in employment status from that of an employee to that of an independent contractor did not constitute a separation from the service within the meaning of section 402(e)(4)(A)(iii). Thus, the distribution in the amount of $150,744 received by petitioner in July of 1979 was not a lump-sum distribution as defined in section 402(e)(4)(A), and, consequently, petitioner is not entitled to use the 10-year averaging method provided by section 402(e)(1) in reporting this distribution.

To reflect the foregoing,

Decision will be entered for the respondent.

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[20] See also *Addison v. Commissioner*, T.C. Memo. 1979–317.

DONALD A. NAFTEL, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 28089–82. Filed September 30, 1985.

In his pleadings, P alleged that refund checks issued by R and due to P were misappropriated by P's attorney. R's deficiency computation takes into account the refunds issued to P. P argues that the deficiency should be reduced to the extent that refund checks were issued to him but never received by him. R filed a motion for partial summary judgment on the premise that the Court does not have jurisdiction to consider the question of whether the amount of the deficiency should reflect refunds issued by R and not received by P. *Held*: It is within the Court's jurisdiction to consider the question of whether P should be credited with refunds issued by R in determination of a deficiency or overpayment. Accordingly, R's Motion for Partial Summary Judgment is denied.

Joseph F. Moore and *Jonathan B. Cole*, for the petitioner.
Darren M. Larson, for the respondent.

OPINION

PANUTHOS, *Special Trial Judge*:[1] This case is before the Court on respondent's motion for partial summary judgment filed pursuant to Rule 121.[2] By his motion,[3] respondent seeks a determination that this Court does not have jurisdiction to consider petitioner's contention that the deficiency determined against him should be credited to the extent of refund checks issued by respondent but not received by petitioner. For each of the years at issue, petitioner claims that any refund check issued to him was cashed over his forged endorsement by his former attorney, Charles Berg. Respondent issued a statutory notice of deficiency on September 3, 1982. The notice determined deficiencies against petitioner as follows:

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[1] This case was assigned pursuant to Rule 180 et seq., Tax Court Rules of Practice and Procedure.

[2] All Rule references are to the Tax Court Rules of Practice and Procedure.

[3] Respondent selected three cases as representative of a group of more than 300 cases currently pending before the Court. Counsel for petitioners in each of the three cases represent a significant number of other petitioners in the group. The issue for decision is common throughout the group. The opinions in the other two docketed cases, *Rosenberg v. Commissioner*, docket No. 28854–82 and *Cornick v. Commissioner*, docket No. 17425–82, are issued concurrently as T.C. Memo. 1985–514 and T.C. Memo. 1985–513, respectively.

Year	*Deficiency*
1976	$539
1977	718
1978	4,098
1979	4,155
1980	2,397

In his notice of deficiency, respondent determined that petitioner was not entitled to claimed investment credits and losses generated by a limited partnership known as Vandenburg Co.[4] The limited partnership was created to acquire and distribute master recordings.[5]

Petitioner became a limited partner on the advice of his attorney, Charles Berg. At the time he became involved with the partnership, petitioner believed his participation would enable him to generate enough losses and credits in his first year so that he would receive refunds of taxes withheld and paid in previous years. Petitioner's tax returns for the years 1978, 1979, and 1980 were prepared by Berg, or persons connected with his office, and the address shown on the forms was attorney Charles Berg's address. The Application for Tentative Refund (Form 1045) sought to carry back unused investment credits from the year 1979 to the years 1976, 1977, and 1978. The 1979 and 1980 Federal income tax returns claimed losses from Vandenburg Productions. Thus petitioner claimed overpayments for which respondent issued refund checks.

Petitioner never received some or all of the refund checks which he expected as a result of his participation in the limited partnership. Despite repeated attempts, petitioner was unsuccessful in receiving his refunds. Petitioner claims that Berg fraudulently endorsed and negotiated the refund checks and misappropriated the proceeds of the checks.[6]

Rule 121 provides that a party may move for summary judgment upon all or any part of the legal issues in controversy so long as there is no genuine issue of material fact.[7] Rule 121(b) provides that "a decision shall * * * be rendered if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials * * * show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." The Rule further provides that "partial summary adjudication may be made which does not dispose of all issues in the case." *Elkins v. Commissioner*, 81 T.C. 669, 674 (1983). The burden of proving that there is no genuine issue of material fact is on the moving party. *Take v. Commissioner*, 82 T.C. 630, 633 (1984); *Graf v. Commissioner*, 80 T.C. 944, 946 (1983); *Espinoza v. Commissioner*, 78 T.C. 412, 416 (1982). Therefore, respondent must prove that the Tax Court lacks jurisdiction to consider the question of petitioner's missing refund checks.

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[4] On his tax returns, petitioner refers to the company as Vandenburg Productions while elsewhere he refers to it as Vandenburg Co. We will use both names interchangeably.

[5] Respondent also disallowed other deductions which do not pertain to the issue raised in respondent's motion.

[6] In the summer of 1981, petitioner became aware of a criminal investigation of Charles Berg which was being conducted by the Internal Revenue Service and the U.S. Secret Service. At that time, petitioner ascertained that he was but one of many of Berg's clients who had been part of Berg's scheme to defraud clients of their refund checks.

In addition, we must view the factual materials and inferences drawn therefrom in the light most favorable to the party opposing the motion. *Estate of Gardner v. Commissioner*, 82 T.C. 989, 990 (1984); *Elkins v. Commissioner*, *supra*; *Jacklin v. Commissioner*, 79 T.C. 340, 344 (1982). As a result, the facts set forth herein are taken from petitioner's pleadings, both admitted and denied, and from the petitioner's and attorney's affidavits in opposition to respondent's motion. The facts are viewed in the terms most favorable to petitioner. *Estate of Gardner v. Commissioner*, *supra*.

It is well settled that the Tax Court is a court of limited jurisdiction, and we may exercise our jurisdiction only to the extent authorized by Congress. Sec. 7442;[8] *Commissioner v. Gooch Milling & Elevator Co.*, 320 U.S. 418 (1943); *Kluger v. Commissioner*, 83 T.C. 309, 314 (1984); *Medeiros v. Commissioner*, 77 T.C. 1255, 1259 (1981). It is equally true that, generally, once a petitioner invokes the jurisdiction of the Court, jurisdiction lies with the Court and remains unimpaired until the Court has decided the controversy. *Dorl v. Commissioner*, 57 T.C. 720, 722 (1972), affd. 507 F.2d 406 (2d Cir. 1974).[9]

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[7] Petitioner argues that we should treat respondent's motion as a motion to strike under Rule 52 rather than as a motion for summary judgment under Rule 121. Respondent, however, is not arguing that petitioner's allegations are immaterial or frivolous. A motion to strike will be granted only if the moving party establishes that a pleading has no possible bearing on the subject matter being litigated or if he proves that prejudice will result to him unless the motion is granted. See *Estate of Jephson v. Commissioner*, 81 T.C. 999, 1000 (1983); *Samuel Goldwyn, Inc. v. United Artists Corp.*, 35 F. Supp. 633, 637 (S.D.N.Y. 1940); *In Re Beef Industry Antitrust Litigation*, 600 F.2d 1148, 1168–1169 (5th Cir. 1979). Rule 121(b) states that a party may move for summary adjudication upon all or any part of the legal issues in controversy. The scope of our jurisdiction, which is the matter raised by respondent's motion, is a legal issue to be considered upon a motion for summary judgment and not in the context of a motion to strike.

[8] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise indicated.

The question of the Court's jurisdiction is fundamental and must be addressed when raised by a party or on the Court's own motion. See *Estate of Young v. Commissioner*, 81 T.C. 879, 880–881 (1983); *Midland Mortgage Co. v. Commissioner*, 73 T.C. 902, 905 (1980); *Intervest Enterprises, Inc. v. Commissioner*, 59 T.C. 91, 94 (1972); *Goldstein v. Commissioner*, 22 T.C. 1233, 1236 (1954).[10] If we find that we do not properly have jurisdiction to consider an issue, then despite a party's choice of the Tax Court as a forum to settle the dispute, we may not decide the issue. *Wheeler's Peachtree Pharmacy, Inc. v. Commissioner*, 35 T.C. 177, 179 (1960); *Shelton v. Commissioner*, 63 T.C. 193 (1974); *Herbert Brush Manufacturing Co. v. Commissioner*, 22 B.T.A. 646, 647 (1931).

In general, Tax Court jurisdiction exists only if a valid statutory notice of deficiency has been issued by the Commissioner and a timely petition has been filed therefrom. Secs. 6212 and 6213; Rules 13 and 20; *Midland Mortage Co. v. Commissioner*, *supra* at 907.[11] It is not the actual existence of a deficiency on which the Court's jurisdiction is based, rather it is the Commissioner's determination of a deficiency which provides the basis for our jurisdiction. *Hannan v. Commissioner*, 52 T.C. 787, 791 (1969); *Intervest Enterprises, Inc. v. Commissioner*, *supra* at 95.

A deficiency is generally defined as an amount by which the income, gift, or estate tax due under the law exceeds the amount of such tax shown on the return. Sec. 6211;[12] *Bregin v.*

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[9] See also *Stafford v. Commissioner*, T.C. Memo. 1983–650.

[10] See also *Engel v. Commissioner*, T.C. Memo. 1958–52.

[11] See also *Stevenson v. Commissioner*, T.C. Memo. 1982–16.

[12] Sec. 6211 provides in pertinent part—

> SEC. 6211(a). IN GENERAL.—For purposes of this title in the case of income, estate, and gift taxes imposed by subtitles A and B and excise taxes imposed by chapters 41, 42, 43, 44, and 45 the term "deficiency" means the amount by which the tax imposed by subtitle A or B, or chapter 41, 42, 43, 44, or 45 exceeds the excess of—
>
> (1) the sum of
>
> (A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus
>
> (B) the amounts previously assessed (or collected without assessment) as a deficiency, over—
>
> (2) the amount of rebates, as defined in subsection (b)(2), made.

Commissioner, 74 T.C. 1097, 1102 (1980). A deficiency is neither a theory nor an intangible concept. *Veeder v. Commissioner*, 36 F.2d 342, 343 (7th Cir. 1929).[13] An instance in which the issuance of a statutory notice of deficiency does not confer jurisdiction on the Court occurs when a notice of deficiency is erroneously issued after payment of the tax. *Bendheim v. Commissioner*, 214 F.2d 26, 28 (2d Cir. 1954); *Anderson v. Commissioner*, 11 T.C. 841, 843 (1948).[14]

We have jurisdiction to decide not only whether the Commissioner's determination of a deficiency was correct, but also whether a taxpayer's claim that he has overpaid is correct. *Russell v. United States*, 592 F.2d 1069, 1071 (9th Cir. 1979); *Estate of Parshelsky v. Commissioner*, 303 F.2d 14, 22 (2d Cir. 1962). Section 6512(b)(1) gives the Court jurisdiction to determine an overpayment.[15] Respondent argues that because Congress has developed a separate statutory scheme for recovery of stolen or forged refund checks, the Court cannot consider petitioner's claim of overpayment, even though excess withholding credits are included in the definition of an overpayment[16] and even though the Court has jurisdiction to determine an overpayment. We do not agree that our jurisdiction is barred by this separate statutory scheme.

In determining the amount of an overpayment for the year in which the Commissioner has determined a deficiency, we may take into account payments made by a taxpayer through withholding or by payment of estimated income tax. If these payments exceed the income tax liability for the year in controversy, then an overpayment exists. *Keefe v. Commissioner*, 15 T.C. 947, 955–956 (1950). In fact we recently held that our jurisdiction to determine an overpayment includes the power to consider interest as part of an overpayment. *Estate of Baumgardner v. Commissioner*, 85 T.C. 445 (1985).

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[13] See also *Luke v. Commissioner*, T.C. Memo. 1964-176.

[14] See also *Stroman v. Commissioner*, T.C. Memo. 1978-96.

[15] Sec. 6512(b)(1) provides in pertinent part—

> SEC. 6512(b). Overpayment Determined by Tax Court.—
>
> (1) Jurisdiction to determine.— * * * if the Tax Court finds that there is no deficiency and further finds that the taxpayer has made an overpayment of income tax for the same taxable year * * * the Tax Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Tax Court becomes final, be credited or refunded to the taxpayer.

[16] Sec. 6401 provides—

> SEC. 6401(a). Assessment and Collection After Limitation Period.—The term "overpayment" includes that part of the amount of the payment of any internal revenue tax which is assessed or collected after the expiration of the period of limitation properly applicable thereto.

We have previously faced a problem similar to the one presented in the instant case. See *Bolnick v. Commissioner*, 44 T.C. 245 (1965). In *Bolnick*, we held that we would consider the amount claimed by taxpayers on their return as an overpayment, despite the fact that respondent's records indicated a refund check had been issued. In that case, taxpayers maintained that they never received a refund of $778.90 for the taxable year for which respondent had determined a deficiency. We received evidence on the issue and ultimately concluded that there was an overpayment. For our purposes, the important fact is not that the Court decided that taxpayers had made an overpayment; instead, what is significant is the fact that the Court considered the taxpayers' claim.[17] In reaching this conclusion we stated that:

> Our jurisdiction is precisely circumscribed by statute and we can only determine the amount of a deficiency or of an overpayment in income tax—or of both—for the taxable year for which respondent has determined a deficiency. Sec. 6512(b), I.R.C. 1954. But in determining the amount of an overpayment, albeit for the same year for which we may determine a deficiency, we are to take into account payments made by the taxpayer by withholding and by payments on declaration of estimated tax, and if the total of such payments exceeds income tax liability for the year in controversy, we are to determine an overpayment. *Ernest J. Keefe*, 15 T.C. 947 (1950). [*Bolnick v. Commissioner, supra* at 258.][18]

We do have jurisdiction to determine whether or not petitioner received his refund checks, and if not, whether the amount due him in refunds constitutes an overpayment or reduces the deficiency. Since the function of this Court is to adjudicate deficiency disputes, if we could not consider the issue of petitioner's nonreceipt of his refunds, then we would be without an essential power to fulfill our duties. See *Stevens v. Commissioner*, 709 F.2d 12 (5th Cir. 1983).

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[17] See also *Weiner v. Commissioner*, T.C. Memo. 1971-56, in which we received evidence concerning taxpayer's receipt or non-receipt of his refund check and the effect of that fact on the ultimate fact to be decided, the proper amount of a deficiency or overpayment.

[18] As we pointed out in *Bolnick v. Commissioner*, 44 T.C. 245 (1965), the provisions of sec. 6512(b)(2) define the parameters of our jurisdiction to consider this point. We may take into account the amount of the taxpayer's refund in determining an overpayment "if we find that a timely claim for refund for the amount could have been filed (whether or not it was in fact filed) on the date that the statutory notice of deficiency was mailed." *Bolnick v. Commissioner, supra* at 260; sec. 6512(b)(2).

When a notice of deficiency is mailed to a taxpayer he has two options, one is to petition the Tax Court before payment of the tax, and the other is to pay the tax and sue for a refund in a district court or in the United States Claims Court. Sec. 7422(a) and (e);[19] *Drake v. Commissioner*, 554 F.2d 736, 739 (5th Cir. 1977).[20] Once a taxpayer chooses to litigate his claim in the Tax Court, we have exclusive jurisdiction over the issues involved in adjudicating the tax liability. *Dorl v. Commissioner, supra* at 720: sec. 6512(a). We acquire jurisdiction when a taxpayer files with the Court and that jurisdiction extends to the entire subject matter of the correct tax for the taxable year. See *Erickson v. United States*, 309 F.2d 760, 767, 159 Ct. Cl. 202, 216 (1962); *Peters v. United States*, 618 F.2d 125, 222 Ct. Cl. 534 (1979); *Russell v. United States, supra* at 1071.

A dichotomy exists between our function with respect to overpayments and respondent's responsibility to make refunds. While the Court has jurisdiction to determine an overpayment, it has no authority to order or deny a refund. *U.S. ex rel Girard Trust Co. v. Helvering*, 301 U.S. 540, 542 (1937); *Hollie v. Commissioner*, 73 T.C. 1198, 1204 (1980).[21] Taxpayers have access to the district courts or Claims Court if any refund suit were necessary. *U.S. ex rel Girard Trust Co. v. Helvering, supra*.

Respondent's argument that petitioner cannot pursue his contention in the Tax Court because Congress has developed a scheme for recovery of stolen Treasury checks misses the point.[22] Petitioner bases his petition on his claim that no deficiency exists or that there is, perhaps, an overpayment because he has already paid taxes in the amount of the refund checks. Petitioner does not base his claim on the checks themselves.

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[19] Sec. 7422(a) provides—

SEC. 7422(a). NO SUIT PRIOR TO FILING CLAIM FOR REFUND.—No suit or proceeding shall be maintained in any court for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected, or of any penalty claimed to have been collected without authority, or of any sum alleged to have been excessive or in any manner wrongfully collected, until a claim for refund or credit has been duly filed with the Secretary, according to the provisions of law in that regard, and the regulations of the Secretary established in pursuance thereof.

Sec. 7422(e) provides—

SEC. 7422(e). STAY OF PROCEEDINGS.—If the Secretary prior to the hearing of a suit brought by a taxpayer in a district court or the United States Claims Court for the recovery of any income tax, * * * mails to the taxpayer a notice that a deficiency has been determined in respect of the tax which is the subject matter of taxpayer's suit, the proceedings in taxpayer's suit shall be stayed during the period of time in which the taxpayer may file a petition with the Tax Court for a redetermination of the asserted deficiency, and for 60 days thereafter. If the taxpayer files a petition with the Tax Court, the district court or the United States Claims Court, as the case may be, shall lose jurisdiction of taxpayer's suit to whatever extent jurisdiction is acquired by the Tax Court of the subject matter of taxpayer's suit for refund. * * *

[20] See also *Stafford v. Commissioner*, T.C. Memo. 1983-650; *Vickers v. Commissioner*, T.C. Memo. 1983-429.

[21] See also *Fink v. Commissioner*, T.C. Memo. 1984-505.

Petitioner faces two problems: (1) A determination of a deficiency in his income tax liability for certain years and (2) nonreceipt of his refund checks. The Tax Court has jurisdiction to determine whether or not a deficiency or an overpayment exists. Should we ultimately find that petitioner has overpaid his taxes, and respondent refuses to credit or refund petitioner's taxes, then petitioner may resort to a Federal district court or the United States Claims Court for recovery. *U.S. ex rel Girard Trust Co. v. Helvering, supra*; *Robbins Tire & Rubber Co. v. Commissioner*, 53 T.C. 275, 279 (1969).[23] We have no jurisdiction over a recovery, but this is not what petitioner is seeking in the Tax Court.

The statutory scheme set out at 31 U.S.C. section 3343 provides only a method for recovering a lost or stolen refund check. If we limit petitioner's remedies to that plan, we would effectively be denying him his right to petition this Court for a redetermination of his income tax liability. Congress has nowhere indicated that a taxpayer must follow one path to the exclusion of the other. Petitioner can proceed in this Court while continuing to pursue his claim with the Division of Check Claims. It is true that a decision rendered by either the Court or the Division of Check Claims may have an impact on the proceedings in the other forum; however, we will not and cannot relinquish jurisdiction because a recovery method exists which ought to relieve petitioner of his problem with respect to recovery of his refund checks.[24]

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[22] Congress established a recovery plan for people whose Treasury checks have been stolen or lost without any fault by the claimant. See 31 U.S.C. sec. 3343. There is a four prong recovery test which a claimant must satisfy in order to recover: (1) The check was lost or stolen without fault of the payee; (2) the check was negotiated and paid on a forged endorsement of the payee's name; (3) the payee did not participate in any part of the proceeds of the negotiation; and (4) recovery from the forger on the check after the forgery has been or may be delayed or unsuccessful. 31 U.S.C. sec. 3343(b).

[23] *See also Rosenberg v. Commissioner*, T.C. Memo. 1970-201.

[24] Petitioner submitted a claim in the spring or summer of 1982 to the Division of Check Claims, Bureau of Government Operations, Department of Treasury asking that replacement refund checks be issued to him. No final action has been taken yet, apparently because of missing information about his claim, and the fact that Charles Berg, who allegedly forged the

Judicial economy requires that all issues raised in a case be tried and settled in one proceeding; this has long been our policy. Cf. *Estate of Baumgardner v. Commissioner*, 85 T.C. 445 (1985); *Markwardt v. Commissioner*, 64 T.C. 989, 998 (1975) (where we denied the taxpayer's request for a second trial when he attempted to raise a new issue not raised at the first trial); *Robin Haft Trust v. Commissioner*, 62 T.C. 145, 147 (1974) (where we denied the taxpayer's request for reconsideration of our opinion and to vacate our decision). When we are presented with a case over which we have jurisdiction and in which we possess the necessary and usual powers to resolve the dispute, we must consider all the issues raised by the case. See *Kluger v. Commissioner*, 83 T.C. 309, 314 (1984). Since petitioner has properly invoked the jurisdiction of this Court, if we do not consider whether or not petitioner received his refund checks, we would leave an essential issue unaddressed. The consequences of omitting consideration of this issue might well require additional hearings and evidence, thus placing an undue burden on the Court as well as the parties.

There are factual and legal questions which we need not decide at this time. We make no finding herein as to whether respondent properly computed the deficiency. The question of whether the deficiency should be reduced to the extent that refunds were issued by respondent and not received by petitioner will be decided on another day.

Based on the foregoing, respondent's motion is denied.

An appropriate order will be issued.

Charles Adler and Edwina Adler, Petitioners v. Commissioner of Internal Revenue, Respondent

Docket No. 19836–83. Filed October 7, 1985.

Upon the facts, *held*:

1. The errors in Ps' return did not constitute "mathematical or clerical errors appearing on the return" within the meaning of sec. 6213(f)(2), I.R.C. 1954, of the Code.

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endorsements and cashed the refund checks, has fled from the country. A separate grand jury investigation is being conducted to investigate Berg. The files which Berg kept on each of his clients, including petitioner, are part of the grand jury material and cannot yet be released to the Division of Check Claims.

2. The errors in Ps' return were of a type encompassed within a limited extension of the statute of limitations granted by Ps, and R's notice of deficiency was therefore timely.

Alan A. Davidson, for the petitioners.
Caroline R. Ades, for the respondent.

OPINION

KÖRNER, *Judge*: Respondent determined a deficiency in petitioners' income tax for the calendar year 1978 in the amount of $25,765. After agreement by the parties on an unrelated matter,[1] the sole issue which we must determine is whether respondent's statutory notice of deficiency for 1978 was issued after the expiration of the effective statute of limitations under section 6501.[2]

The case was submitted to the Court on a fully stipulated set of facts and exhibits pursuant to the provisions of Rule 122, and our findings of fact herein are based upon such stipulated facts and documents.

At the time their petition was filed herein, petitioners were residents of Kinnelon, New Jersey.

Petitioners timely filed their joint individual income tax return for the calendar year 1978 with respondent at Holtsville, New York. On July 20, 1979, petitioners filed Form 1040X, amending their 1978 income tax return. The changes related to capital gain income, interest income, and dividend income, and disclosed an additional tax liability, which respondent assessed on or about February 4, 1980. On March 17, 1981, petitioners and respondent executed a partial agreement of increased tax liabilities for 1978, arising from a reduction in the sales tax deductions claimed by petitioners. The agreement executed by petitioners consenting to the assessment of such additional deficiencies stated on its face that it did not include any agreement as to adjustments relating to petitioners' participation in an entity known as Envirogas Drilling, and stated that any adjustments related to that entity would be proposed upon completion of a further examination. In May 1982, petitioners filed a second form 1040X, further amending their 1978 income tax return, and claiming an increased investment tax credit for the year 1978.[3]

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[1] The parties have agreed that respondent's examination of petitioners' 1981 return will determine the amount of investment tax credit carryback to the year 1978 to which petitioners are entitled in that year, and that such amount may be incorporated in the recomputation of tax liability for 1978 which will be entered as the decision of this Court pursuant to Rule 155.

[2] All statutory references are to the Internal Revenue Code of 1954 as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

Among the items reported in petitioners' 1978 return were losses, and related items, with respect to certain limited partnership interests which petitioner Charles Adler held in certain partnerships, as follows:

(1) Petitioner Charles Adler held limited partnership interests in seven limited partnerships, grouped together under the heading of "Envirogas Drilling Programs." The results of these seven partnerships were combined for purposes of reporting in petitioners' return, and a single net loss figure was reported. Other pertinent figures with respect to these seven partnerships were likewise aggregated for tax reporting purposes, e.g., excess intangible drilling costs, tax preference net income or loss, and depletion.

(2) Petitioner Charles Adler had a limited partnership interest in an organization known as "Perry Drilling 1978, Ltd.," from which a net loss for 1978 was likewise reported.

Respondent undertook an audit of the partnership returns of the seven partnerships in the Envirogas Drilling Programs group. As the result of a partial audit of these returns, respondent and petitioner agreed upon various adjustments to the income, deductions, and/or credits in six of the seven Envirogas partnerships, and petitioners and respondent entered into a partial agreement, as the result of which petitioners' distributive share of losses from the Envirogas Drilling Programs was reduced by $9,326 for the taxable year 1978. As in the case of the prior agreement between the parties, this agreement, dated December 16, 1982, was specific that it was only a partial agreement with respect to that year.

Apparently in recognition of the fact that a complete examination of petitioners' affairs and 1978 return was not yet concluded, petitioners, on January 20, 1982, executed on Form 872-A a "Special Consent to Extend the Time to Assess Tax" with respect to the calendar year 1978. Said consent was accepted on behalf of respondent on January 29, 1982. Under the terms of the agreement, the statute of limitations with respect to respondent's right to assess deficiencies in petitioners' 1978 income was extended for an indefinite period. The agreement specified that the indefinite extension of the statute of limitations would be terminated only as follows, viz, on or before 90 days after the first to occur of the following events: (a) notification in writing by either party to the other party of the termination of the Special Consent, on Form 872-T, or (b) the issuance by respondent of a statutory notice of deficiency for the year 1978.

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[3] See note 1 *supra*.

In addition, the Special Consent agreement entered into by the parties was further limited in its scope, in that the agreement specifically provided as follows:

> The amount of any deficiency assessment is to be limited to that resulting from any adjustments to (1) items affected by the continuing tax effects caused by adjustments to any prior tax return; (2) your distributive share of any items of income, gain, loss, deduction or credit of, or distribution from the entities known as Envirogas Drilling Programs; (3) the tax basis of your interest in Envirogas Drilling Programs; (4) the return of the aforementioned entity which also affects your return and; (5) including any consequential changes to other items based on such adjustment.
>
> The use of the term entity is without prejudice to the right of the commissioner to to [sic] challenge whether such entity exists, or, if existing, the character of such entity.

Incorporated with petitioners' 1978 tax return was Form 4625 (Computation of Minimum Tax — Individuals) in which petitioners reported their items of tax preference, as defined by section 57, for purposes of the minimum tax imposed by section 56. The return form reported the following amounts of tax preference items:

Depletion	$2,958
Capital gains	813,944
Intangible drilling costs	15,581
Total tax preference items reported	832,483

The above reporting of tax preference items in petitioners' 1978 return was in error in at least two respects:

(1) No amount should have been reported as a tax preference item from depletion.

(2) The correct figure for intangible drilling costs should have been $191,474.[4]

The above errors were committed by petitioners' tax return preparer, who misinterpreted and incorrectly reported on Form 4625 figures supplied to petitioners by Envirogas Drilling Program on Schedule K-1 which gave, separately and in total, pertinent figures with respect to the results of the seven Envirogas Drilling Program partnerships in which petitioner Charles Adler was a participant in 1978. Such schedule was not included as a part of petitioners' return, and the errors were not apparent from the return itself or any schedule attached thereto. The tax preference item for intangible drilling costs, as it related to the Perry Drilling 1978 Ltd., in the amount of $15,581, was correctly reported.

On April 14, 1983, the statutory notice of deficiency at issue herein was mailed to petitioners. At that time, neither petitioners nor respondent had terminated the period of assessment for the year 1978 by notification to the other party, as provided in Form 872-A.

The sole issue between the parties is whether respondent's statutory notice of deficiency was timely issued within the applicable period of limitations provided by section 6501(a).[5] Petitioners contend that respondent's statutory notice was not timely issued under the applicable 3-year statute. Respondent contends that the notice of deficiency was timely sent within the period of a valid consent executed by petitioners, extending the statute of limitations, as provided in section 6501(c)(4).[6]

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[4] Computed as follows:

Intangible drilling costs from Envirogas Drilling Program	$178,851
Less: Amount as reported	- 2,958
	175,893
Add: Perry Drilling 1978 Ltd	+ 15,581
Total intangible drilling costs	191,474

[5] As relevant herein, sec. 6501(a) and (b) provides as follows:

> (a) GENERAL RULE. —Except as otherwise provided in this section, the amount of any tax imposed by this title shall be assessed within 3 years after the return was filed (whether or not such return was filed on or after the date prescribed) * * * and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period.
>
> (b) TIME RETURN DEEMED FILED.—
>
> (1) EARLY RETURN.—For purposes of this section, a return of tax imposed by this title, * * * filed before the last day prescribed by law or by regulations promulgated pursuant to law for the filing thereof, shall be considered as filed on such last day.

[6] As relevant herein, sec. 6501(c)(4) reads as follows:

> (4) EXTENSION BY AGREEMENT.—Where, before the expiration of the time prescribed in this section for the assessment of any tax imposed by this title, * * * both the Secretary and the

In opposition to respondent's claim of a valid consent extending the period of limitations herein, petitioners urge that the consent which they issued was strictly limited in its scope to certain types of adjustments which respondent was permitted to make to petitioners' return, and that the adjustments which respondent made were outside the scope of that limited consent, and that the statutory notice herein was therefore untimely and invalid.

The bar of the statute of limitations is an affirmative defense, and the party raising it must specifically plead it and carry the burden of proof with respect thereto. Rules 39, 142(a). Where the party pleading such issue makes a showing that the statutory notice was issued beyond the normally applicable statute of limitations, however, such party has established a prima facie case. At that point, the burden of going forward with the evidence shifts to the other side, and the other party has the burden of introducing evidence to show that the bar of the statute is not applicable. Where the other party makes such a showing, the burden of going forward with the evidence then shifts back to the party pleading the statute, to show that the alleged exception is invalid or otherwise not applicable. The burden or proof, i.e., the burden of ultimate persuasion, however, never shifts from the party who pleads the bar of the statute of limitations. See *Stern Bros. & Co. v. Burnet*, 51 F.2d 1042 (8th Cir. 1931), affg. 17 B.T.A. 848 (1929); *Concrete Engineering Co. v. Commissioner*, 58 F.2d 566 (8th Cir. 1932), affg. 19 B.T.A. 212 (1930); *Estate of Williams v. Commissioner*, T.C. Memo. 1955–321.

In the instant case, as we have found, petitioners timely filed their joint tax return for 1978, which means that it is deemed to have been filed on April 15, 1979. Sec. 6501(b). Under ordinary circumstances, then, the period within which respondent could validly issue a notice of deficiency with respect to the year 1978 would have expired on April 15, 1982. Sec. 6501(a). Respondent's statutory notice herein was not issued until April 14, 1983. Petitioners therefore established a

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taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

prima facie case that the statutory notice was barred by the period of limitations, and the burden of going forward then shifted to respondent.

Respondent met that burden by introducing in evidence a consent, valid on its face and executed prior to the expiration of the 3-year statute, extending the period of limitations with respect to the year 1978 indefinitely, subject to termination as therein provided, and as we have found in our findings of fact. Respondent further established that no such termination had taken place at the time his statutory notice of deficiency herein was issued. The burden of going forward then shifted back to petitioners to show that such consent was ineffective to extend the period of limitations until the time respondent's statutory notice herein was issued on April 14, 1983. Petitioners seek to meet that burden by advancing two separate and unrelated arguments:

(1) Petitioners argue that the errors committed by their tax return preparer in Form 4625, as outlined in our findings of fact, were mere mathematical or clerical errors, within the meaning of section 6213(b)(1), and that such mathematical or clerical errors are to be corrected by respondent through the use of the summary assessment procedures provided in said subsection, without the issuance of a statutory notice of deficiency which would give this Court jurisdiction under section 6213(a). This being true, petitioners argue that the consent which they issued on Form 872-A could not, as a matter of law, extend the period of limitations within which respondent could use his available summary assessment procedures to correct such mathematical or clerical errors.

We need not decide this novel issue, for which petitioners cite no authority, because the whole argument rests upon the premise that the adjustments made by respondent here constituted the correction of a "mathematical or clerical error appearing on the return" within the meaning of section 6213(b)(1), and we hold that they did not.

Section 6213(f)(1) (now section 6213(g)(1)) defines a "return" to include "any return, statement, schedule, or list, and any amendment or supplement thereto, filed with respect to any tax imposed by subtitle A or B, or chapter 41, 42, 43, or 44." It is thus clear that the Form 4625 attached to petitioners' 1978 return was part of their "return" within the meaning of the statute.

Section 6213(f)(2) (now section 6213(g)(2)) further provides a definition of "mathematical or clerical error" as that phrase is used in section 6213(b)(1).[7] An examination of that subsection makes it clear that the errors which were committed in petitioners' return do not fit within any of the given definitions of mathematical or clerical error. What are present here are not typographical errors, or errors of addition, subtraction, multiplication, or division which would be apparent on the face of the Form 4625 or from any other document comprising petitioners' return. Nor were the stipulated errors inconsistent with any other item shown in the return which would permit respondent to detect and correct them. Rather, the errors committed here by the tax return preparer were substantive: he reported one figure as representing depletion, when in fact no such figure should have been reported, and he reported another figure as representing intangible drilling costs, when in fact such figure was substantially erroneous. In both cases, such errors were not obvious on their face, and there was nothing else in petitioners' return which would have made it apparent that they were errors. We accordingly find petitioners' argument on this point to be without merit.

(2) Petitioners next argue that respondent's adjustments giving rise to the instant notice of deficiency were outside the special limitations in the consent which petitioners signed, in that, say petitioners,

> such Special Consent was limited, by agreement with respondent, to a deficiency assessment resulting from, or arising out of, certain adjustments to the return of Envirogas Drilling Programs. No such adjustment having

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[7] As in effect for the year 1978, sec. 6213(f)(2) provided as follows:

(2) MATHEMATICAL OR CLERICAL ERROR.—The term "mathematical or clerical error" means—

(A) an error in addition, subtraction, multiplication or division shown on any return,

(B) an incorrect use of any table provided by the Internal Revenue Service with respect to any return if such incorrect use is apparent from the existence of other information on the return,

(C) an entry on a return of an item which is inconsistent with another entry of the same or another item on such return,

(D) an omission of information which is required to be supplied on the return to substantiate an entry on the return, and

(E) an entry on a return of a deduction or credit in an amount which exceeds a statutory limit imposed by subtitle A or B, or chapter 41, 42, 43, or 44, if such limit is expressed—

(i) as a specified monetary amount, or

(ii) as a percentage, ratio, or fraction, and if the items entering into the application of such limit appear on such return.

been made to the return of Envirogas Drilling Programs affecting petitioners' return, the proposed deficiency is time-barred.

In making this argument, it is apparent that petitioners are concentrating their attention upon that portion of the special limitations in the consent which petitioners signed (quoted in their entirety in our findings of fact, *supra*) which states:

> The amount of any deficiency assessment is to be limited to that resulting from any adjustments to * * * (4) the return of the aforementioned entity [Envirogas Drilling Programs] which also affects your return * * *

Petitioners ignore, however, that portion of the special limitation which reads:

> The amount of any deficiency assessment is to be limited to that resulting from any adjustments to * * * (2) your distributive share of any items of income, gain, loss, deduction or credit of, or distribution from the entities known as Envirogas Drilling Programs; * * *

In our view, this last quoted portion of the special limitations of the consent fits the instant situation. Conceding that there was apparently no adjustment to the Envirogas Drilling Programs' return, so far as the figures in question are concerned, subdivision (2) of the Special Consent does not impose any such requirement. What happened here was that petitioners' return preparer erroneously reported in their return two items constituting petitioners' distributive share of tax preference income from the Envirogas Drilling Programs, misinterpreting and misapplying information supplied by Envirogas. Under the clear and unambiguous language of the special limitation which we have quoted, there was no requirement that respondent's adjustment here be made because of corresponding adjustments which he may have made to the returns of Envirogas Drilling Programs.

We accordingly hold that the adjustments made in respondent's statutory notice herein were clearly within the terms of the Special Consent executed by petitioners extending the statute of limitations, and that respondent's statutory notice was therefore timely.

Decision will be entered under Rule 155.

Roger L. Ewart, Fiduciary, and Transferee of the Assets of the Estate of Blanche L. Ewart, Deceased, Transferor, Petitioner v. Commissioner of Internal Revenue, Respondent

Docket No. 27544–83. Filed October 8, 1985.

P and R each seek judgment as a matter of law in their favor. The issue for determination is whether P is liable as a transferee under sec. 6901(a)(1)(A)(ii), I.R.C. 1954, or as a fiduciary under sec. 6901(a)(1)(B).

D died an Ohio domiciliary, and her two sons were appointed as coexecutors of her estate. P, one of the coexecutors, received a notice of deficiency (liability) as a fiduciary and beneficiary of the estate. P's purported liability is based on the transfer of property from the estate which rendered the estate insolvent. This transfer was made without consideration and prior to the payment of the additional estate tax liability determined by R. Prior to the issuance of the notice, P's coexecutor executed a waiver of restrictions on assessment and collection of the estate tax. P did not execute the waiver.

Held, R has made the requisite showing that there is no genuine issue of material fact as to P's liability as a transferee under sec. 6901(a)(1)(A)(ii), I.R.C. 1954, and R's motion for summary judgment is granted.

Gerald B. Graham, for the petitioner.
James V. Moroney, for the respondent.

OPINION

Hamblen, *Judge*: This case is before the Court on the parties' cross motions for summary judgment pursuant to Rule 121.[1]

Respondent issued a notice of deficiency (liability) addressed to petitioner as fiduciary and transferee of the Estate of Blanche L. Ewart on June 24, 1983. In the notice of deficiency (liability), respondent determined that petitioner was liable for a deficiency of $14,637.55 and an addition to the tax under sections 6651(a)(3) of $3,659.39.

Respondent filed his motion for summary judgment on September 24, 1984. In his motion, respondent claims that there is no genuine issue of material fact relating to petitioner's liability as a transferee and that respondent is entitled to judgment as a matter of law.[2] Petitioner filed his motion on November 8, 1984. In his motion, petitioner claims that there is no genuine issue of material fact relating to the binding effect of a waiver executed by his coexecutor and consequently that he is entitled to judgment as a matter of law as to his liability as a fiduciary and transferee.

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[1] All Rule references are to the Tax Court Rules of Practice and Procedure. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the taxable years in issue.

A hearing was held on the parties' motions at Cleveland, Ohio, on December 10, 1984. Counsel for both parties appeared and presented argument. At the conclusion of the hearing, both motions were taken under advisement.

Blanche L. Ewart died on April 30, 1978, and her will was admitted to probate in Summit County, Ohio, on May 9, 1978. Petitioner and his brother, John L. Ewart (John), were coexecutors of the Estate of Blanche L. Ewart. Beryl H. Haught, Jr. (Haught), was the attorney representing the estate.

Petitioner and John were the sole beneficiaries under the Will of Blanche L. Ewart. Petitioner received, in part, a specifically described parcel of real estate. John received the remainder of the real estate. On the inventory and appraisal filed with the Probate Court on January 30, 1979, the real estate received by petitioner was valued at $60,000, and the real estate received by John was valued at $165,000. The inventory and appraisal was signed by John, alone. Petitioner filed an objection to the inventory and appraisal on February 8, 1979, but withdrew this objection. An order approving the inventory was entered on February 19, 1979.

In February of 1979, petitioner and John executed an agreement relating to the distribution of the estate. This agreement provided, in pertinent part:

> WHEREAS various differences have arisen between the said parties as to the valuation of the assets in said estate, * * *
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> * * * * * * *
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> 3. If at any time in the future the Blanche L. Ewart estate is re-appraised to include the buildings or raise the valuation of the 86 acres willed to John

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[2] Respondent does not assert that he is entitled to summary judgment on the basis of petitioner's fiduciary status.

> L. Ewart, he must pay this increase in taxes, interest or penalties when due on this re-appraisal.
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> 4. If at any time in the future the Blanche L. Ewart estate is re-appraised to raise the valuation of the 30 acres willed to Roger L. Ewart, he must pay this increase in taxes, interest or penalties when due on this re-appraisal.

On February 20, 1979, petitioner and John simultaneously received the real estate devised to them under the will. This transfer was without consideration.[3] After the transfer, the estate was insolvent. All of the assets of the estate had been distributed prior to December 31, 1979. John sold the real estate transferred to him 6 months after the distribution and received net proceeds of $212,000. At the time of the commencement of this proceeding, John had filed a petition in bankruptcy.

A Form 706, U.S. Estate Tax Return, was filed for the estate on January 29, 1979. The Federal estate tax return listed petitioner and John as "Deceased's personal representative or persons in possession of property." The value of the real estate transferred to John was listed on the return at the value stated on the inventory and appraisal. The Federal estate tax return was signed by John, as personal representative or person in possession of property, and by Haught, as the return preparer. Haught was also given authorization to receive confidential information relating to the return. Petitioner did not sign the return.

In addition to the Federal estate tax return, a Form 1041, U.S. Fiduciary Income Tax Return, was filed for the estate. The return was signed by John, as fiduciary. Petitioner did not sign the return.

The Internal Revenue Service audited the Federal estate tax return and, in the course of the audit, increased the value of the property devised to John. The increased amount was identical to the difference between the value of the real estate received by John as reported on the Federal estate tax return and the net proceeds which John received on the sale of this property. On January 26, 1980, a Form 890, Waiver of

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[3] The fiduciary's account filed on August 7, 1979, shows "real property transferred" in the amount of $225,000. There is no corresponding entry under receipts showing that consideration was received for this transfer. We do note that the final fiduciary's account filed on May 27, 1980, did show a receipt in the amount of $31,367.28 designated as "Money advanced by heirs to pay the estate debts & taxes."

Restrictions on Assessment and Collection of Deficiency and Acceptance of Overassessment—Estate and Gift Tax, was signed by John and Haught as executors or administrators of the Estate of Blanche L. Ewart. Petitioner did not sign the waiver.

A decision will be rendered on a motion for summary judgment if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law. Rule 121(b). The burden of proving that there is no genuine issue of material fact is on the moving party. See *Adickes v. Kress & Co.*, 398 U.S. 144, 157 (1970)[4]; *Graf v. Commissioner*, 80 T.C. 944, 946 (1983); *Espinoza v. Commissioner*, 78 T.C. 412, 416 (1982). The opposing party is to be afforded the benefit of all reasonable doubt, and any inference to be drawn from the underlying facts contained in the record must be viewed in a light most favorable to the party opposing the motion for summary judgment. *Espinoza v. Commissioner, supra* at 416. Where both parties submit motions for summary judgment, each motion must be examined to determine if the moving party has established that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law. *Take v. Commissioner*, 82 T.C. 630, 633 (1984).

A fact is material if it "tends to resolve any of the issues which have been properly raised by the parties." C. Wright, A. Miller & M. Kane, 10A Federal Practice and Procedure: Civil, sec. 2725 (2d ed. 1983). Our rules require that the petition contain clear and concise assignments of each error which petitioner alleges to have been committed by respondent. Rule 34(b)(4); *Jarvis v. Commissioner*, 78 T.C. 646, 658 (1982). Any issue not raised in the assignments of error shall be deemed conceded. Rule 34(b)(4); *Jarvis v. Commissioner, supra* at 658. Further issues may be raised by respondent in his answer. Rule 36(b). Our rules also provide that any issue tried by the express or implied consent of the parties shall be treated as if it were raised in the pleadings. Rule 41(b)(1).

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[4] Summary judgment under Rule 121 is derived from rule 56, Fed. R. Civ. P. Hence, in any question turning on the interpretation of Rule 121, the history of rule 56, Fed. R. Civ. P., and the authorities interpreting such rule are considered by the Tax Court. See *Hoeme v. Commissioner*, 63 T.C. 18, 21 (1974); *Shiosaki v. Commissioner*, 61 T.C. 861, 862 (1974).

Here, the petition does not clearly articulate what errors petitioner alleges were committed by respondent. However, an examination of the petition in light of petitioner's subsequent motion for summary judgment and other materials in the record indicates that petitioner's assignment of error is predicated on his argument that the Form 890 signed by John and Haught was not binding on the estate as one coexecutor cannot confess judgment against the estate without notice to or knowledge of the other coexecutor.[5] On this basis, petitioner argues that he is entitled to judgment as a matter of law as to both his liability as a fiduciary and as a transferee. Respondent argues that John and Haught's execution of the Form 890 was binding on the estate and that there is no genuine issue of material fact as to petitioner's liability as a transferee.

Binding effect of the Form 890

Both petitioner and respondent have raised an issue in relation to the binding effect of the Form 890 executed by John and Haught pursuant to the provisions of section 6213(d). Petitioner claims that the execution of the Form 890 was not binding on the estate. Respondent asserts that the execution of the Form 890 was binding on the estate. To the extent that this issue is relevant to a determination of petitioner's liability, we must agree with respondent.

Initially, petitioner argues that under the law of the State of Ohio, both coexecutors must act in order to bind the estate to a waiver of restrictions on assessment and collection under section 6213(d).[6] "Executor" as used in title 26, Internal Revenue Code, in connection with the Federal estate tax imposed by chapter 11, is a Federal law concept. Sec. 2203; *DeNiro v. United States*, 561 F.2d 653, 657 (6th Cir. 1977). For purposes of title 26, in connection with the taxes imposed by chapter 11, Estate Tax, executor is defined as:

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[5] Petitioner misconstrues the effect of the execution of the Form 890. Execution of a Form 890 prior to the receipt of a notice of deficiency merely precludes the Tax Court as a forum for litigating the deficiency. Sec. 6213(a). The taxpayer may pursue a refund action pursuant to sec. 7422.

[6] Petitioner's position is based on the authority of one coexecutor to act under Ohio law. Petitioner concludes that one coexecutor may not sign a Form 890 without the concurrence of other coexecutors, citing *Harrold v. Romick*, 17 Ohio L. Abs. 467 (Hardin County App. 1934). That case is distinguishable from the situation here. In *Harrold v. Romick*, *supra*, one coexecutor allowed a claim and the other disallowed the same claim. Petitioner presents no authority for the proposition that one executor cannot bind his coexecutors in the absence of conflicting actions by the coexecutors. The supreme court of the State of Ohio has clearly adopted the position that one executor can bind the estate without the concurrence of his coexecutors. *Rammelsberg v. Mitchell and Lape*, 29 Ohio St. 22, 50 (1875).

> the executor or administrator of the decedent, or, if there is no executor or administrator appointed, qualified, and acting within the United States, then any person in actual or constructive possession of any property of the decedent. [Sec. 2203.][7]

The Federal tax laws impose duties and responsibilities on those persons who are executors within the statutory definition of section 2203. The specific responsibilities enumerated in connection with the Federal estate tax include filing a Federal estate tax return for the decedent's estate under section 6018(a) and paying the Federal estate tax under section 2002. In addition the executor, in connection with the Federal estate tax, may waive the restrictions on assessment and collection of the tax under section 6213(d).

The Federal tax laws do not affirmatively require that more than one person who is defined as an executor perform any acts in connection with the Federal estate tax liability. Although there is no statutory or judicial interpretation of section 2203 which would clarify whether all coexecutors must perform all acts jointly where more than one executor is appointed,[8] cases interpreting the provisions for waiver of the statute of limitations on assessment and collection of Federal income taxes attributable to the decedent clearly permit one coexecutor to act irrespective of State law requirements. *Darcy v. Commissioner*, 26 B.T.A. 841, 849 (1932), affd. on another issue 66 F.2d 581 (2d Cir. 1933); *Bartlett v. Commissioner*, 16 B.T.A. 510, 513 (1929). We can determine no reason to apply a different rule when one coexecutor acts in connection with the provisions of the Federal estate tax law. Consequently, we find that one coexecutor may bind the estate through the execution of a waiver of restrictions on assessment and collection under section 6213(d).[9]

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[7] We have discussed the limitations on the use of the definition of executor found in sec. 2203 outside the Federal estate tax area in *Occidental Life Insurance Co. of California v. Commissioner*, 50 T.C. 726 (1968).

[8] Sec. 20.6018–2, Estate Tax Regs., requires that a return be made "jointly" by all if there is more than one executor. However, we have explained that the purpose of this regulation is to prevent the filing of more than one tax return and not to require that all coexecutors sign the Federal estate tax return. *Doriss v. Commissioner*, 3 T.C. 219, 230 (1944).

Petitioner's second and final argument is that irrespective of the power of one coexecutor generally to bind the estate on execution of a waiver of the restrictions on assessment and collection under section 6213(d), this rule is inapplicable, here, because respondent was notified of petitioner's fiduciary relationship. Apparently petitioner is arguing that there was notice under section 6903. Petitioner contends that the information on the Forms 706 and 1041 filed by the estate was sufficient to notify respondent that petitioner was a fiduciary acting for the estate. We do not agree.

The Form 706 listed petitioner as a "personal representative *or* [a person] in possession of property." (Emphasis added.) Petitioner was not named on the Form 1041. Petitioner neither signed the Form 706 nor did he sign the Form 1041 submitted to respondent. Clearly, in this circumstance it would be impossible for respondent to determine whether petitioner was a fiduciary under section 6903.[10] Consequently, we find that petitioner has not provided notice of his fiduciary relationship under section 6903.[11]

Respondent has submitted a copy of the Form 890 with his motion. There is nothing in the record which raises an inference that the Form 890 was not effective to waive the restrictions under section 6213(d) other than the arguments raised by petitioner which we have rejected. Consequently, we find that there is no genuine issue of material fact as to the binding nature of the Form 890.

Petitioner's status as a transferee

Respondent claims that petitioner meets all the requisite elements of a transferee under section 6901(a)(1)(A)(ii).[12] It is well established that the provisions of section 6901 do not create transferee liability but merely provide a procedural mechanism for the Commissioner to pursue the Government's claim against a transferee. *Commissioner v. Stern*, 357 U.S. 39, 42 (1958). The Government's rights as a creditor against the transferee must be determined under the applicable State law. *Commissioner v. Stern, supra* at 45. Here, the applicable State law is that of Ohio.

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[9] Our conclusion is further supported by sec. 6903 which permits one fiduciary to act alone where notice is given to the Secretary. Clearly, this provision does not contemplate that State law will control the ability of fiduciaries to act on behalf of the taxpayer.

[10] See note 7 *supra*. A fiduciary for purposes of sec. 6903 would not necessarily include a statutory executor under sec. 2203.

[11] We decline to consider whether under other circumstances the filing of a Federal estate tax return is sufficient notice under sec. 6903. See *Estate of McElroy v. Commissioner*, 82 T.C. 509, 512–513 (1984).

[12] In his answer, respondent raised an issue as to petitioner's status as a transferee under sec. 6324(a)(2). Respondent does not specifically address petitioner's liability under this provision in his motion. We note that it is unlikely in this instance that sec. 6324(a)(2) would apply to petitioner as the property which he received was apparently included in the decedent's gross estate under sec. 2033 and not under secs. 2034 to 2042. *Groetzinger v. Commissioner*, 69 T.C. 309, 316 (1977).

Ohio law provides that any conveyance made by a person who is or will thereby be rendered insolvent is fraudulent as to creditors irrespective of actual intent if the conveyance is made without fair consideration. Ohio Rev. Code Ann. sec. 1336.04 (Page 1979). A person is insolvent when the present fair salable value of his assets is less than the amount that is required to pay the probable liability on existing debts as they become absolute and matured. Ohio Rev. Code Ann. sec. 1336.02 (Page 1979). Where there is a fraudulent conveyance within the meaning of the act, a creditor may generally attach or levy execution on the property conveyed. Ohio Rev. Code Ann. sec. 1336.09 (Page 1979).

Here, all of the requisite elements to proceed against petitioner as a transferee of a fraudulent conveyance under Ohio law are present. Petitioner does not dispute the amount of additional Federal estate tax liability, or the addition to tax,[13] or that these amounts have not been paid. Petitioner concedes that the distribution on February 20, 1979, rendered the estate insolvent. Petitioner and John did not pay any consideration for the transfers. Consequently, the transfers to petitioner and John were fraudulent conveyances within the definition of Ohio Rev. Code Ann. sec. 1336.04 (Page 1979), and petitioner is liable as a transferee under section 6901.

Petitioner concedes that the fair market value of the property at the date of distribution was $60,000. As the fair market value of the property received by petitioner is in excess of the unpaid tax liability of the estate, petitioner is liable for the full Federal liability of the estate, including interest.[14] *Lowy v. Commissioner*, 35 T.C. 393, 396–397 (1960).

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[13] Even had petitioner not conceded the amount of the deficiency and the addition to tax in his petition, we would have granted summary judgment to respondent on this issue. Petitioner has presented no facts which would controvert respondent's determination. In such circumstances, summary judgment for respondent is appropriate. *Abrumo v. Commissioner*, 78 T.C. 154, 163-164 (1982).

On the basis of this record, we must grant respondent's motion for summary judgment.

We recognize that the result we reach here may appear harsh as to petitioner, although clearly mandated by statute. While we sympathize with petitioner, the record indicates that he was aware of problems in the administration of the estate and that he may have relied on the agreement with his brother John to his disadvantage. Hopefully, however, John's bankruptcy proceedings will not preclude petitioner's claim for reimbursement from John in keeping with their contract.

To reflect the foregoing,

Decision will be entered for the respondent.

HENRY SOLOWIEJCZYK AND ANITA SOLOWIEJCZYK, PETITIONERS V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 25566–82. Filed October 9, 1985.

Petitioners timely filed their 1978 Federal income tax return on or before Apr. 15, 1979. Based on his finding that petitioners had a substantial underpayment attributable to a tax motivated transaction under sec. 6621(d)(3)(A)(i), I.R.C. 1954, for tax year 1978, respondent sought application of the increased rate of interest under sec. 6621(d) with respect to interest on petitioners' underpayment of their 1978 tax liability which accrued after Dec. 31, 1984 (the effective date of that section). *Held*, application of sec. 6621(d) to interest which accrued after the effective date of that section on petitioners' underpayment of their 1978 tax liability does not constitute retroactive application of sec. 6621(d). *Held, further*, petitioners are not liable for damages under sec. 6673.

Howard Mann, for the petitioners.
Lewis R. Mandel, for the respondent.

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[14] Respondent concedes that no interest is currently due on the addition to tax under sec. 6651(a)(3).

WRIGHT, *Judge*: Respondent determined a deficiency of $41,089 in petitioners' 1978 Federal income tax. Petitioners have conceded that they are liable for the entire deficiency. The issues for decision are (1) whether sections 6621(d)(1)[1] and 6621(d)(3)(A)(i) are unconstitutional as applied herein; (2) whether petitioners are liable for damages under section 6673; and (3) whether section 6673 is unconstitutional as applied herein.

FINDINGS OF FACT

The petitioners, Henry Solowiejczyk (hereinafter referred to as petitioner), and Anita Solowiejczyk resided in Long Beach, New York, when the petition herein was filed.

On their 1978 Federal income tax return, which was filed on or before April 15, 1979, petitioners claimed various deductions and credits relating to their alleged purchase of certain book properties. The underlying deficiency in this case resulted from respondent's disallowance of those deductions and credits. Respondent's disallowance was based upon his determination that petitioner's book publishing activity was not an activity entered into for profit under section 183(a). In addition, respondent disallowed petitioner's claimed depreciation deduction on four grounds, including a finding that a certain nonrecourse note lacked economic substance and could not, therefore, be added to petitioner's basis in the book.

The petition in this case was filed on October 25, 1982. On February 9, 1983, respondent began discovery with an informal request that petitioners produce certain documents and answer certain interrogatories. Receiving no response, on June 13, 1983, respondent served formal requests for production of documents and interrogatories on petitioners. When petitioners failed to respond, respondent, on August 10, 1983, filed a Motion to Compel Production of Documents and to Impose Sanctions, and a Motion to Compel Responses to Respondent's Interrogatories and to Impose Sanctions. In response to these motions, petitioners requested that they be granted additional time, until October 15, 1983, to comply. The Court allowed the additional time and, after petitioners' partial compliance, granted a further extension, until November 18, 1983.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

This case was set for trial at the trial session commencing October 15, 1984. Subsequently, petitioners' Motion for Continuance, filed September 12, 1984, was denied and trial was scheduled for October 25 and 26, 1984. On October 15, 1984, respondent filed an Amendment to Answer alleging that petitioners are liable for damages under section 6673. On October 22, 1984, petitioners' counsel requested a continuance due to a medical problem. Because of the circumstances, respondent had no objection and the case was continued to the trial session commencing January 7, 1985. Petitioners filed a Motion for Continuance on December 27, 1984, and renewed that motion at the calendar call on January 7, 1985. The motion was denied and trial was scheduled for January 15 and 16, 1985. On January 14, 1985, petitioners advised respondent that they intended to concede the deficiency.

On January 17, 1985, respondent filed a Second Amendment to Answer alleging that petitioners are liable for interest under section 6621(d). In a joint stipulation filed with this Court on the same date, petitioners concede the entire amount of the deficiency determined by respondent, but contest the applicability and constitutionality of section 6673, and further contest the constitutionality of section 6621(d), as applied herein. Petitioners concede, however, that they are liable for interest under sections 6621(d)(1) and 6621(d)(3)(A)(i), without admitting that the transactions in question are transactions described in those sections, if this Court determines that those sections are not unconstitutional.

After concessions by petitioners, the issues are (1) whether sections 6621(d)(1) and 6621(d)(3)(A)(i) are unconstitutional as applied herein; (2) whether petitioners are liable for damages under section 6673; and (3) whether section 6673 is unconstitutional as applied herein.

OPINION

The first issue is whether the application of section 6621(d) to the facts presented herein is unconstitutional. Section 6621(d) provides for an increase in the rate of interest payable under section 6601 with respect to "any substantial underpayment" (an underpayment exceeding $1,000) "which is attributable to 1 or more tax motivated transactions." Sec. 6621(d)(1) and (2).

Respondent seeks application of section 6621(d) on the ground that petitioners are liable for a substantial underpayment for 1978 which is attributable to a tax motivated transaction under section 6621(d)(3)(A)(i). Section 6621(d)(3)(A)(i) defines a tax motivated transaction as "any valuation overstatement (within the meaning of section 6659(c))." Petitioners contend that section 6621(d)(3)(A)(i) may not be applied to returns filed before January 1, 1982, because section 6659(c) is effective only as to returns filed after December 31, 1981. Thus, they assert that a "valuation overstatement" can exist only in the context of a return filed after that date. They argue that application of section 6621(d) to an understatement arising from a return filed before the effective date of section 6659(c) results in the retroactive application of section 6621(d). Petitioners conclude that such retroactive application of a "penalty-like" statute violates the due process clause of the Fifth Amendment and is, therefore, unconstitutional.

We do not agree with petitioners' contention that section 6621(d) is being retroactively applied. The issue for decision herein centers upon the imposition of an increased rate of interest pursuant to section 6621(d). Section 6659(c) comes under consideration only with respect to the definition of valuation overstatement contained therein, which is incorporated by reference into section 6621(d)(3)(A)(i). Although section 6659(c) is effective only for tax returns filed after December 31, 1981, no addition to tax pursuant to section 6659(c) is sought herein and, therefore, the limitation with respect to application of that statute is irrelevant. Section 6621(d) was enacted on July 18, 1984, and is effective as to interest accruing after December 31, 1984. Respondent here seeks to apply that section to interest which accrued after December 31, 1984, on petitioners' underpayment of their 1978 tax liability. The event which subjects petitioners to the imposition of section 6621(d) is not the filing of their 1978 tax return, but the existence, beyond the effective date of section 6621(d), of an underpayment attributable to a valuation overstatement. We do not find that this constitutes a retroactive application of section 6621(d). See *Hockaden & Associates,* *Inc. v. Commissioner*, 84 T.C. 13 (1985) (application of section 4975 to loans which were obtained before the effective date of that section but which remained outstanding after such date did not constitute retroactive application of section 4975). Compare *Estate of Papson v. Commissioner*, 81 T.C. 105 (1983) (an amendment to the statutory rate of interest had a retroactive effect to the extent it applied to liabilities which arose before the effective date of the amendment and continued to be outstanding thereafter).

Petitioner further argues that applying section 6621(d) to the facts presented here requires application of the provisions of section 6659(c) to a tax return filed more than 1 year before the effective date of that section, a result not intended by Congress.

We reiterate, however, that the issue presented here is imposition of an increased rate of interest pursuant to section 6621(d). We have found nothing to support the restricted application of that section urged by petitioners. To the contrary, in connection with the enactment of section 6621(d) the Conference Committee stated that "The provision is effective with respect to interest accruing after December 31, 1984, *regardless of the date the return was filed.*" H. Rept. 98-861 (Conf.), 1984-3 C.B. (Vol. 2) 1, 239 (emphasis added). We believe that Congress intended that we make broad use of our authority to impose additional interest on substantial underpayments of tax attributable to tax motivated transactions. See *Law v. Commissioner*, 84 T.C. 985 (1985); *Johnson v. Commissioner*, 85 T.C. 469 (1985).

Based on the foregoing, we find that sections 6621(d)(1) and 6621(d)(3)(A)(i) are not unconstitutional as applied herein.

The next issue is whether petitioners are liable for damages under section 6673. As applicable herein, section 6673 provides that damages up to $5,000 shall be awarded to the United States whenever it appears that proceedings before the Tax Court have been instituted or maintained primarily for delay or that the taxpayer's position in such proceedings is frivolous or groundless. After careful consideration of the entire record in this case, in our discretion, we have determined that damages pursuant to section 6673 will not be awarded. Accordingly, we need not address the constitutionality of that section. We note, however, that the Court of Appeals for the

Second Circuit and this Court recently have found that the imposition of damages under section 6673 did not violate the constitutional rights of the taxpayers involved. *Connor v. Commissioner*, 770 F.2d 17 (2d Cir. 1985) affg. an unreported decision of this Court; *Bell v. Commissioner*, 85 T.C. (1985).

To reflect concessions and the foregoing,

Decision will be entered under Rule 155.

STANLEY BECK AND HELEN BECK, PETITIONERS V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 25003-82. Filed October 10, 1985.

Petitioner purchased the rights to a book and arranged for independent parties to publish and distribute the book. *Held*, based on the entire record, petitioner's activity with respect to the book did not constitute an activity engaged in for profit.

Guy P. Lander and *Leonard R. Glass*, for the petitioners.
Gregg M. Weiss and *Lewis R. Mandel*, for the respondent.

COHEN, *Judge*: Respondent determined deficiencies in petitioners' Federal income tax of $41,293 for 1978 and $17,272 for 1979. After concessions by petitioners, the issues for decision are as follows: (1) Whether petitioner Stanley Beck's activity in connection with the publication of a certain book constituted an activity engaged in for profit, and (2) if so, whether a nonrecourse promissory note given as part of the consideration for rights to the book was a genuine indebtedness.[1] The parties raised various other issues which, in view of our holding herein, we need not and do not address.

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[1] Parties in the following cases have agreed to be bound by the result in this case: Julius Kahn and Isabel Kahn, docket No. 25742-82; Jerry J. Jerome and Beverly E. Jerome, docket No. 9194-83; Edward Feldman and Janice Feldman, docket No. 9195-83; Louis Kawesch and Sheila Kawesch, docket No. 9196-83; Robert M. Rosen and Marilyn R. Rosen, docket No. 9197-83; Seymour Feldman, docket No. 22906-83; Florence Feldman Lubotta, docket No. 31746-83, and Seymour Feldman, docket No. 18675-84.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioners Stanley Beck (petitioner) and Helen Beck resided in Flushing, New York, at the time they filed their petition herein. They filed joint individual income tax returns for 1978 and 1979.

Since 1953 and during the years in issue, petitioner was a commercial artist and photographer whose primary clients were national television networks. Petitioner's art and photography activities did not involve any facet of the acquisition, production, or distribution of books or any other type of publication. Prior to 1978, petitioner had never purchased any book or publication for production and sale. In that year, petitioner's accountant and tax adviser, Robert M. Rosen (Rosen), suggested that petitioner acquire a book in the "Famous First Series" investment program offered by Contemporary Perspectives, Inc. (CPI).

CPI was a New York corporation engaged in the publishing and editorial development business. CPI created children's educational books and nonprint media for its own publication and for other publishers. Stephen P. Berner (Berner) and Arthur Rosenberg (Rosenberg) organized CPI in 1976 and were its principal officers and stockholders. Prior to forming CPI, Berner and Rosenberg were high-level executives with Random House, Inc. (Random House) and possessed considerable experience and expertise in educational publishing.

Soon after its formation, CPI was retained by the Baker & Taylor Co., a major book jobber, to organize a series of conferences for reading and education specialists, primarily librarians and teachers. In such conferences, which CPI conducted in various major U.S. cities, CPI presented the new educational publications of approximately 90 publishers. CPI also used the conferences to discover additional markets that it might exploit. Based upon conversations with persons attending the conferences, Berner and Rosenberg concluded that there existed a need for highly interesting yet easily readable nonfiction books to develop the skills of children with reading and language problems.

Berner and Rosenberg concluded that publishing such books would be particularly appropriate for a small company like CPI. They believed that the books would involve less risk and would provide more stable and longer-term returns than would aspiring "best sellers" and "blockbusters."

Berner and Rosenberg decided that CPI should publish the books in series, with each series centered around a particular theme. Through the assistance of education experts, CPI would control the reading difficulty of each book within a series.

After consulting various financial institutions, Berner and Rosenberg concluded that CPI would have difficulty obtaining conventional financing for development of the books. Moreover, they believed that establishing a significant presence in the market through the publication of many titles was important for a small, young company like CPI. Therefore, instead of retaining ownership of the books to be published, CPI decided to sell to investors the rights to the books in each series prior to publication and distribution of the books.

In 1977 CPI began publication of its first two series of children's books, "Unsolved Mysteries" and "Myths, Magic and Superstitions." Based upon the initial results of these two series, CPI was optimistic about the future of its children's books series.

In late 1977 or early 1978, CPI began development of its Famous First Series. The Famous First Series consisted of 25 titles conceived by CPI's editors, including "America's First Football Game," "First to the Moon," "The First Woman in Congress: Jeanette Rankin," and the book ultimately purchased by petitioner, "When TV Began: The First TV Shows" ("When TV Began").

After CPI's editors created each of the 25 titles, CPI contracted with various outside authors, many of whom had experience writing for children, to write the initial manuscripts for the books. The agreement between CPI and Sally Berke (Berke), chief of the Language Arts Department of "Readers' Digest" and author of "When TV Began," illustrates the typical arrangement CPI had with the outside authors. In the agreement, dated February 28, 1978, Berke agreed to research, write, and convey to CPI her entire interest in "When TV Began" in exchange for $500.

Upon receipt of the manuscript from an author, CPI reviewed the work and, based upon that review, might have the manuscript rewritten or restructured by a second writer. Employees of CPI then edited each book for language to assure proper readability and vocabulary levels.

Contemporaneously with the development of the books, CPI began a search for a distributor for the Famous First Series. After receiving bids from several distribution companies, CPI accepted the offer of Silver Burdett Co. (Silver Burdett), a subsidiary of Scott, Foresman & Co. and a large, highly respected publisher of educational books.

CPI and Silver Burdett entered into a written agreement dated May 26, 1978, in which CPI granted Silver Burdett the exclusive right to the hard cover library-bound English language edition of each book in the Famous First Series. Silver Burdett agreed to produce, at its own expense, not less than 5,000 copies of such edition for each book. If any title sold out, Silver Burdett undertook a similar obligation to reprint not less than 3,000 copies of the book. Silver Burdett further agreed to perform, at its own expense, all marketing services associated with the books, defined as "promoting, selling, advertising, billing, warehousing, fulfilling, shipping, collecting, bad debt risk, return handling, and all other appropriate customer services for distribution." CPI agreed not to publish a "trade or book club English language edition" of any of the Famous First Series books within 24 months after the date of the agreement. The agreement entitled CPI to royalties equal to 27.5 percent of the net receipts (gross sales revenues less returns) from the sales of the Famous First Series books by Silver Burdett, based on a list price of not less than $7.44 per book, reduced by discounts of 25 percent for sales directly to schools and libraries and 40 percent for sales to wholesalers. Silver Burdett agreed to pay CPI an advance against the above royalties equal to $3,500 per title on January 5, 1979. The agreement was to continue through June 30, 1982, and indefinitely thereafter unless Silver Burdett breached its obligations with respect to reprints or failed to sell at least 5,000 copies of each title by June 30, 1981.

After entering into the distribution agreement with Silver Burdett, CPI attempted to sell its rights in each of the Famous First Series books (subject to the distribution agreement) to various unrelated investors. CPI ultimately sold approximately 20 or 21 of the 25 books to such investors. Only a few of the investors communicated directly with CPI. Instead, most of the investors either had previously invested in CPI books or were clients or colleagues of professionals with whom CPI did business.

Rosen was such a professional: in addition to being petitioner's accountant and tax adviser, he was the accountant for both CPI and Berner. Rosen had no expertise regarding the acquisition, production, publication, or distribution of books or other publications. He received a fee from CPI equal to approximately $1,500 for each of seven or eight investors, including petitioner, that he persuaded to purchase a book in the Famous First Series. Rosen purchased two of the books for himself.

Prior to presenting to petitioner the opportunity of investing in a Famous First Series book, Rosen examined several documents from CPI relating to the investment program. Among these was a document entitled "CONFIDENTIAL OFFERING MEMORANDUM" (the offering memorandum).[2] The offering memorandum provided that the purchaser of a book would acquire all rights in the book for $130,000, $30,000 in cash ($15,000 at closing and $15,000 (plus interest at 8½ percent per annum) on January 15, 1979) and $100,000 by 6-percent, 10-year nonrecourse promissory note. The purchaser would be required to prepay the note to the extent of 50 percent of all sums received by the purchaser from the distribution in the United States and Canada of the hard cover library edition of the book and 70 percent of all other revenues received by the purchaser. Payments on the note would be applied first to interest and then to principal. If the purchaser's share of the revenues from the book was insufficient to pay the note on or before its maturity, CPI's only remedy would be to foreclose upon its retained security interest in the book.

The offering memorandum described the distribution agreement between CPI and Silver Burdett, to which the purchaser's interest in the book would be subject, and an optional distribution agreement between the purchaser and CPI. Under the latter arrangement, the purchaser could elect to appoint CPI as the exclusive distributor for all rights not subject to the agreement with Silver Burdett, and CPI would be entitled to a commission equal to 5 percent of all gross revenues received with respect to such rights.

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[2] Petitioner was unable to produce for trial the offering memorandum with respect to "When TV Began." He nevertheless stipulated that the offering memoranda relating to Famous First Series books were identical in all material aspects. The record herein includes the offering memorandum with respect to "America's First Football Game."

The offering memorandum further provided, in relevant part:

> This investment is available only to a purchaser whose net worth is at least $125,000, and some portion of whose annual gross income would be subject to Federal income tax at a rate of 50% or higher: or who has anticipated gross income during 1978 and 1979 in excess of $75,000 per year. See the acquisition agreement attached as an exhibit hereto with respect to certain representations and warranties which a purchaser will be required to make.
>
> * * * * * * *
>
> Leonard R. Glass, Esq., Special Counsel to Contemporary Perspectives, Inc., in connection with this memorandum, * * * is available to answer questions of purchaser or his representative concerning any aspect of this offering.
>
> * * * * * * *
>
> 1. An investment in the publication and other commercial exploitation of a literary property generally, and specifically in the field of children's books, is highly speculative and has historically involved a substantial degree of risk. Revenues, if any, are dependent upon the sales success of the Book and the successful exploitation of the subsidiary rights (non-publishing) of the Book. Sales appeal of the Book and related subsidiary rights depend upon factors such as (i) the efforts of the Distributor, including its willingness to expend monies on advertising and promotion (which is not mandatory under the terms of the Distribution Agreement), and to fulfill its other obligations under the Distribution Agreement with the Purchaser; and (ii) critical reviews in trade publications and industry reaction over which the Purchaser will have no control. Even if the Book is a critical or artistic success, there is no assurance that sufficient income will be realized in order to return Purchaser's investment.
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> * * * * * * *
>
> Children's books are sold primarily to libraries and educational institutions. Public funding of both public libraries and educational institutions has been reduced in recent years as a result of general economic conditions and cuts in public funding. In the absence of a major increase in the funds available to fund public libraries and educational institutions, the primary market for the Book may be further restricted in the near future.
>
> 3. The Seller, which is in the publishing business, owns and will acquire other literary properties and intends to sell and/or distribute these literary

> properties to other purchasers. Such purchasers may retain the Distributor to promote their books. To this extent, Seller and Distributor may be direct competitors of the Purchaser. The Purchaser and the Distributor will be in competition with other book publishers and distributors, many of which have substantially greater financial resources, larger distribution staffs and more established business histories in the book and literary properties business. In spite of these credentials, certain of these other companies have encountered financial difficulties which reflect the highly competitive character and unpredictability of public reaction to literary properties.
>
> * * * * * * *
>
> It is anticipated that the primary sales of the Book will be to schools and libraries in the United States.
>
> * * * * * * *
>
> The Purchaser should be allowed to amortize the cost of the Book by means of the "Income Forecast" method whereby cost (less estimated residual value) may be amortized on a weighted basis in accordance with anticipated revenue. * * *

Rosen also considered an opinion letter to CPI from Leonard R. Glass (Glass), who was to receive $3,000 from each investor's initial cash investment, which analyzed the tax consequences of an investment in a Famous First Series book. The letter stated that the investor should be able to use the income forecast method of depreciation, which the letter described as follows:

> The "income forecast" method of depreciation attempts to allocate the taxpayer's cost for an asset based upon the flow of the income from the asset rather than upon the mere passage of time. Under this method of depreciation for a book, the owner of a book is allowed to depreciate the cost of the book (less a reasonable salvage value) over the period during which it is expected to produce income in proportion to projected realization of net receipts after distribution expenses for each taxable year over the period. Thus, the owner's depreciation deduction for any particular taxable year is equal to:

$$\frac{\text{Actual net receipts from the book in taxable year}}{\text{Estimated total net receipts to be derived during useful life}} \times \text{Cost of the book (less salvage value)}$$

Rosen examined an "appraisal" of "When TV Began" prepared by Brent Collins (Collins), then an executive with Random House. At the request of CPI, Collins prepared appraisals for each of the Famous First Series books. In the

"When TV Began" appraisal, as in each of the other appraisals, Collins projected total returns from all rights to the book (subject to the distribution agreement with Silver Burdett) equal to $243,700. Collins concluded that the life of the book would be 12 years and that $190,000 of the total projected returns would result from book sales. He predicted total returns from book sales to schools and libraries of $69,100, based upon the direct sale of 45,000 copies of the hard cover edition. Collins projected total unit sales of 278,000 copies. Collins determined his projections by adjusting preliminary figures supplied by Rosenberg, who forecasted total returns exceeding $300,000.

Rosen received from CPI and reviewed a document entitled "INVESTMENT REGARDING PURCHASE OF A NEW BOOK," which provided as follows:

POTENTIAL TAX BENEFITS AND CASH FLOW

Year	*Cash investment*	*Anticipated depreciation (A)*	*Cash flow (B)*	*Tax loss*	*Ratio of tax loss to investment (C)*	*Cash flow and net after tax saving (D)*
1978	$15,000	$49,400	. . .	$49,400	3.29 to 1	$9,700
1979	15,000	74,100	$3,500	74,100	4.94 to 1	23,800
1980	. . .	. . .	. . .	. . .	. . .	. . .
1981	. . .	. . .	. . .	. . .	. . .	. . .
Total	30,000	123,500	3,500	123,500	4.1 to 1	33,500

(A) Computed on the income forecast method assuming a 5% salvage value. The above estimates are based upon assumptions as to estimated receipts from the Book in the taxable year and estimated total net receipts to be derived during its useful life. The depreciation to be taken will ultimately be based upon the actual performance of the Book in distribution and may differ significantly from the above estimates of such depreciation.

(B) The Distributor, Silver Burdett Company, has agreed to pay Purchaser a minimum guaranteed distribution fee of $3,500 on or before January 15, 1979. This payment will be subject to income taxes.

(C) The ratio of tax loss to investment does not give effect to the cash flow of $3,500. Assuming Purchaser is in a 50% tax bracket after Purchaser has paid taxes on the minimum royalty payment, the ratio of losses to cash investment will be increased from 4.1 to 1 to 4.3 to 1.

(D) Assumes that Purchaser is in a 50% tax bracket.

After reviewing the above documents, Rosen contacted Glass to discuss the tax benefits resulting from the purchase of a Famous First Series Book.

Rosen presented the Famous First Series investment opportunity to petitioner in November 1978. At that time, Rosen made available and explained to petitioner the documents that

best copy available

Rosen had previously reviewed. In a letter to petitioner dated November 21, 1978, Rosen stated:

> The recent change in the tax reform law will have dramatic implications on future "tax shelters". The book deal that we discussed the other day has been thoroughly analyzed by myself as well as independent tax attorneys. I am enclosing a copy of a letter from Mr. Leonard Glass as well as a letter of explanation from myself that was sent to several prospective investors.
>
> I am sure you can see the merits of this as an investment as well as for tax shelter dollars. The $15,000 payment in 1978 which will provide you with a $49,000 tax deduction will represent significant dollars saved. The second and final installment is due in January, after a guaranteed payment of $3,500, also in the amount of $15,000. Therefore, your net cash outlay in 1979 is $11,500 with a deduction that year of $30,000.
>
> As there are only 15 books presently available, I think it would be in your best interest to consider this for yourself * * *

Petitioner relied heavily upon Rosen's advice and contacted no one other than Rosen regarding the investment. A factor in petitioner's ultimate selection of "When TV Began" was his professional involvement in the television industry. Petitioner did not read "When TV Began" prior to his purchase of the book.

On December 18, 1978, petitioner and CPI executed all documents necessary to effect petitioner's purchase of "When TV Began" in accordance with the offering memorandum. These documents included a subscription agreement; a contract of sale (entitled "ACQUISITION AGREEMENT"); a check for the $15,000 payable at closing; a negotiable promissory note with respect to the $15,000 cash payment due January 15, 1979; a $100,000 nonrecourse promissory note; a bill of sale transferring all of CPI's rights in "When TV Began" to petitioner; and a security agreement and a financing statement evidencing CPI's security interest in "When TV Began." CPI formally transferred its copyright in "When TV Began" to petitioner on April 18, 1979.

Through an agreement dated December 18, 1978, petitioner exercised the option to make CPI the exclusive distributor for all rights to "When TV Began" not subject to the agreement with Sliver Burdett. In exchange for the 5-percent commission, CPI agreed to:

> (a) Exert reasonable efforts to arrange for the disposition of the aforesaid rights in your behalf;

> (b) Develop concepts based on the Work for use in the educational market;
>
> (c) Consult with any purchaser of said rights concerning marketing, packaging, advertising and editorial development.

The agreement extended for 10 years and was automatically renewable thereafter for an additional 5 years, unless petitioner objected to renewal. Petitioner could cancel the agreement if he did not receive at least $60,000 in gross revenues (after deducting the 5-percent commission) from the exploitation of the rights subject to the agreement within the first 5 years of the agreement.

Petitioner, Rosen, and three other persons who purchased books in the Famous First Series entered into an agreement, dated December 15, 1978, which provided:

> Any income derived from the sale of any of the books shall be deposited by each of the parties into a special account maintained by Rosen and shall be divided equally among all of the parties. In connection with each party's tax return, his tax return shall report his share of the income from the book owned by him even though his actual cash receipts may be less. However, to the extent that said party pays more in taxes than any of the other parties, then there shall be pro rata contribution from the other parties to make up the difference in the income taxes paid. * * *

On November 7, 1980, CPI entered into an agreement with Modern Curriculum Press (MCP) for the distribution of the soft cover classroom English language edition of 45 CPI titles, including the 25 Famous First Series books. In exchange for the exclusive distribution rights in the United States and Canada, MCP agreed to produce, at its own expense, not less than 5,000 copies of such edition of each book, and, if any title sold out, not less than 5,000 copies in reprint. MCP agreed to perform all marketing services associated with the books, defined as "promoting, selling, advertising, billing, warehousing, fulfilling, shipping, collecting, bad debt risk, return handling, and all other appropriate customer services for distribution." The agreement entitled CPI to royalties of 10 percent, 12.5 percent, and 15 percent of the net sales (gross sales revenues less returns) from the first 10,000 copies, the next 15,000 copies, and any additional copies, respectively, of each title. The agreement extended through June 30, 1984, and thereafter unless MCP breached its obligations with respect to reprints or failed to sell at least 10,000 copies of each title by June 30, 1984. At the time of the agreement, MCP expected to sell 20,000 to 25,000 copies of each title over a 10-year period.

Silver Burdett and MCP sold copies of the hard cover and soft cover edition of "When TV Began," respectively, as follows:

Year	*Hard cover*		*Soft cover*
1979	1,638		
1980	1,526		
1981	753		135
1982	317		2,998
1983	151		2,827
1984 (through Sept.)	543	(Approx.)	2,288
Total	4,928		8,248

MCP sold the CPI titles that it distributed only within sets composed of 45 titles and priced at $69.99 each, and thus sales were identical for each of the Famous First Series books. Sales of "When TV Began" by Silver Burdett were above the average for all of the Famous First Series books.

CPI, Silver Burdett, and MCP engaged in reasonable efforts to promote the Famous First Series books and rights thereto. CPI spent approximately $23,500 to create "When TV Began" before turning the book over to Silver Burdett for producing the hard cover edition. The cost to Silver Burdett of manufacturing the Famous First Series books was $0.8359 per copy. Silver Burdett incurred total nonmanufacturing costs (exclusive of royalty payments under the distribution agreement with CPI) of approximately $160,900 with respect to the Famous First Series books through September 1984. MCP spent a total of $208,732 to produce and distribute the 8,248 sets of CPI books that it sold through September 1984. CPI did not engage any distributors other than Silver Burdett and MCP to distribute "When TV Began."

Petitioner and Rosen engaged in very little activity with respect to petitioner's investment in "When TV Began" after petitioner purchased the book. Petitioner never communicated with Silver Burdett and, as of the date of trial, was unaware that CPI engaged MCP to distribute the soft cover edition. Rosen's only contact with Silver Burdett was in connection with discrepancies in royalty payments.

Petitioner did not maintain any books, records, or separate bank accounts with respect to "When TV Began."

CPI's unaudited June 30, 1979, balance sheet, prepared by Rosen, did not report as assets the nonrecourse notes associated with the Famous First Series program. The notes accompanying the financial statements disclosed such nonrecourse notes as a "contingent asset."

In 1983, there were approximately 51,000 public elementary schools, 16,000 private elementary schools, and 15,000 public libraries in the United States. Like the other Famous First Series books, "When TV Began" was a "supplemental reader" and thus, unlike basic textbooks, was not a necessary item for schools and libraries.

Petitioners reported adjusted gross income of $134,285 and $146,234 on their income tax returns for 1978 and 1979, respectively. On Schedule C of their returns, petitioners reported net losses of $49,500 and $30,000 for the 2 years, respectively, in connection with petitioner's interest in "When TV Began." In neither return did petitioners report any income with respect to the book. The loss reported in 1978 consisted of $46,500 depreciation, based upon a reported cost basis of $130,000, and $3,000 legal and professional fees. The loss reported in 1979 consisted solely of depreciation, based upon a reported cost basis of $150,000. Petitioners filed an amended return for 1978 in which they claimed investment tax credit of $15,000 with respect to the book, based upon a reported cost basis of $150,000.

Respondent denied all deductions and investment tax credit associated with petitioner's interest in "When TV Began." Petitioners concede that the deduction for legal and professional fees was in error.[3]

Subsequent to the years in issue, petitioner purchased two additional books or book-related investments offered by CPI. Petitioners reported aggregate net losses with respect to these books of $38,821, $44,479, $40,639, and $15,515 on their tax returns for 1980, 1981, 1982, and 1983, respectively.[4] Petitioners did not report any income or deductions with respect to "When TV Began" on such returns.

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[3] In the stipulation of facts, petitioners further conceded "all issues raised in the notice of deficiency other than disallowance of Schedule C losses claimed with respect to the book." Yet petitioners argue in their briefs that a portion of the purchase price was subject to investment tax credit, an item respondent disallowed in the notice of deficiency. Because of our holding herein, we need not determine the effect of petitioners' stipulation.

[4] We, of course, make no finding as to the validity of the losses reported in the subsequent years. As indicated in our opinion herein, however, in the context of the entire record, petitioner's additional investments are relevant for determining his intention with respect to "When TV Began."

ULTIMATE FINDINGS OF FACT

Petitioner's activities in connection with "When TV Began" were not undertaken or carried out with an actual and honest objective of making a profit.

OPINION

To qualify for the claimed depreciation deductions with respect to "When TV Began," petitioners must demonstrate that the book either was used in a "trade or business" or was held "for the production * * * of income" within the meaning of section 167(a).[5] Under section 48(a)(1), the investment tax credit is allowable only for property with respect to which depreciation (or amortization in lieu thereof) is allowable. Thus, petitioners' right to both depreciation deductions and investment credit depends upon their showing that petitioner's activity with respect to "When TV Began" either constituted a trade or business or was undertaken and carried on for the production of income. See *Flowers v. Commissioner*, 80 T.C. 914, 931 (1983); *Pike v. Commissioner*, 78 T.C. 822, 841–842 (1982), affd. without published opinion 732 F.2d 164 (9th Cir. 1984).[6]

Essential to such a showing is a demonstration that petitioner had "an actual and honest objective of making a profit." *Dreicer v. Commissioner*, 78 T.C. 642, 646 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); *Fuchs v. Commissioner*, 83 T.C. 79, 98 (1984); *Dean v. Commissioner*, 83 T.C. 56, 74 (1984). While a reasonable expectation of profit is not required, petitioner's objective of making a profit must be bona fide. *Fox v. Commissioner*, 80 T.C. 972, 1006 (1983), affd. without published opinion 742 F.2d 1441 (2d Cir. 1984), affd. sub nom. *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affd. without published opinion sub nom. *Zemel v. Commissioner*,

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[5] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

[6] Sec. 183 allows deductions to the extent of gross income with respect to an activity not engaged in for profit. See *Brannen v. Commissioner*, 78 T.C. 471, 499–500 (1982), affd. 722 F.2d 695 (11th Cir. 1984). Because petitioners did not report any income with respect to "When TV Began" during the years in issue, they are entitled to no deductions under sec. 183.

734 F.2d 9 (3d Cir. 1984), affd. without published opinion sub nom. *Rosenblatt v. Commissioner*, 734 F.2d 7 (3d Cir. 1984), affd. without published opinion sub nom. *Krasta v. Commissioner*, 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. *Leffel v. Commissioner*, 734 F.2d 6 (3d Cir. 1984), affd. without published opinion sub nom. *Hook v. Commissioner*, 734 F.2d 5 (3d Cir. 1984). "The courts have used words such as 'basic,' 'dominant,' 'primary,' 'predominant,' and 'substantial' to describe the requisite profit motive." *Lemmen v. Commissioner*, 77 T.C. 1326, 1340 (1981). See also *Herrick v. Commissioner*, 85 T.C. 237, 254 (1985); *Flowers v. Commissioner*, 80 T.C. at 931. "Profit" in this context means economic profit, independent of tax savings. *Herrick v. Commissioner, supra*; *Surloff v. Commissioner*, 81 T.C. 210, 233 (1983).

Whether petitioner possessed the requisite profit objective is a question of fact to be resolved on the basis of all the facts and circumstances.[7] *Elliott v. Commissioner*, 84 T.C. 227, 236 (1985), and cases cited therein. Although no one factor is determinative, greater weight must be given to objective facts than to petitioner's mere statement of his intent. *Siegel v. Commissioner*, 78 T.C. 659, 699 (1982); *Engdahl v. Commissioner*, 72 T.C. 659, 666 (1979); sec. 1.183-2, Income Tax Regs. Moreover, as discussed in greater detail below, the absence of a particular indicia of profit motive may be more significant to our determination that the superficial presence of another indicia. Respondent's determination is presumptively correct, and petitioners bear the burden of proving petitioner's profit objective. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a), Tax Court Rules of Practice and Procedure.

Based upon the entire record, we conclude that petitioner did not engage in the "When TV Began" activity with an actual and honest objective of making a profit but instead engaged in the transaction primarily, if not exclusively, to obtain tax deductions and credits and thereby reduce the tax petitioners would otherwise have to pay on their substantial income from other sources. Petitioners are therefore not entitled to the claimed depreciation deductions or investment tax credit.

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[7] Sec. 1.183-2(b), Income Tax Regs., lists some of the factors to be considered in determining whether an activity is engaged in for profit. The factors listed in the regulation are as follows:

(1) *Manner in which the taxpayer carries on the activity.* * * *
(2) *The expertise of the taxpayer or his advisors.* * * *
(3) *The time and effort expended by the taxpayer in carrying on the activity.* * * *
(4) *Expectation that assets used in activity may appreciate in value.* * * *
(5) *The success of the taxpayer in carrying on other similar or dissimilar activities.* * * *
(6) *The taxpayer's history of income or losses with respect to the activity.* * * *
(7) *The amount of occasional profits, if any, which are earned.* * * *
(8) *The financial status of the taxpayer.* * * *
(9) *Elements of personal pleasure or recreation.* * * *

The crux of petitioner's argument is that petitioner, a person unskilled in business and financial matters, reasonably relied upon others with respect to his investment in "When TV Began." Petitioners contend that the activities of Rosen and the distributors of the book, particularly CPI, indicate that petitioner possessed the requisite profit objective.

Petitioner testified that Rosen recommended "When TV Began" for both its economic and its tax benefits. Petitioner stated that his primary reason for purchasing the book was to acquire an asset that would produce income over a long term. We recognize that a prospective investor might seek and rely upon the advice of one possessing greater expertise in evaluating the economic merits of an investment. We are convinced, however, that Rosen, petitioner's tax adviser who possessed no expertise in publishing, recommended "When TV Began" to petitioner primarily for its tax benefits and that petitioner purchased the book primarily to receive those benefits.

In the November 21, 1978, letter to petitioner, Rosen recommended the purchase of a Famous First Series book "as an investment as well as for tax shelter dollars." The clear focus of that letter, however, was the "tax shelter dollars." Other than the above general reference to investment merits, Rosen made no mention in the letter of the economic benefits of the investment. By contrast, he described in detail the large expected tax deductions resulting from a relatively small cash investment, certified that the investment had been thoroughly analyzed by himself and independent tax attorneys, enclosed Glass' tax opinion letter, and alluded to the impact of tax reform on "future 'tax shelters.' " Based upon the entire letter, we must conclude that in advising petitioner, "it would be in your best interest to consider [purchasing a book]," Rosen recommended the investment as a golden and perhaps final opportunity to obtain the proffered tax benefits. Cf. *Estate of Baron v. Commissioner*, 83 T.C. 542, 555 (1984).

Petitioner contends that Rosen carefully reviewed the offering materials provided by CPI, and based thereon evaluated the economic merits of the investment. Petitioner predictably relies upon the appraisal prepared by Collins and projecting total returns from "When TV Began" of $243,700 over 12 years. The record does not indicate that Rosen was aware of the prior book investment programs offered by CPI and that CPI was optimistic concerning the success of the Famous First Series. The Collins' appraisal, however, constituted the sole specific economic forecast relating to the investment. It is improbable that petitioner and Rosen, both of whom were inexperienced in publishing, would have blindly relied upon an appraisal furnished by the seller, if they had given any serious consideration to the nontax investment merits of "When TV Began," particularly in light of the business risks detailed in the offering memorandum. See *Elliott v. Commissioner*, 84 T.C. at 240.

Indeed, the other documents provided by CPI and reviewed by Rosen and petitioner were so inconsistent with the appraisal to invite, at the very least, questions from a profit-motivated investor. The offering memorandum twice indicated that the primary sales of the book would be to schools and libraries, and yet Collins projected returns from such sales at $69,100, only approximately 36 percent of total returns from book sales. Because Collins assumed that the school and library sales would consist solely of the hard cover edition (which was more profitable than the soft cover edition), his unit sales projections were even more puzzling in light of the statements in the offering memorandum. Collins' forecast of 45,000 copies to schools and libraries represented only approximately 16 percent of the 278,000 total copies he expected to be sold.

In contrast to the Collins' appraisal, the document entitled "INVESTMENT REGARDING PURCHASE OF A NEW BOOK" projected cash flow, excluding tax benefits, of only $3,500, the amount of the advance royalty payable by Silver Burdett in 1979.[8] Like the November 21, 1978, letter from Rosen, the overwhelming majority of the "potential tax benefits and cash flow" detailed in the document were tax benefits. Moreover, the document projected that the entire $130,000 purchase price, less 5-percent salvage value, would be fully depreciated during the first 2 years under the income forecast method, "based upon assumptions as to estimated receipts from the Book in the taxable year and estimated total net receipts to be derived during its useful life." Implicit in the depreciation projection, and explicit in light of the careful description of the income forecast method in both the offering memorandum and Glass' tax opinion letter, was the assumption that "When TV Began" would not provide any economic return after 1979.[9]

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[8] Despite the implication in the document and in Rosen's letter to petitioner, CPI would be entitled to one-half of the advance royalty under the terms of the nonrecourse note. Berner testified that CPI received this amount and applied it against the note balance.

Whereas we would expect an investor motivated by profit and not possessing any publishing experience to seek additional information regarding these obvious yet fundamental warnings, inconsistencies, and omissions in the documents provided by CPI, the only action taken by Rosen or petitioner in this regard was Rosen's contacting Glass with respect to tax consequences. The objective evidence indicates that petitioner's primary motivation in purchasing "When TV Began" was to obtain the large tax benefits projected by CPI and Rosen. See *Herrick v. Commissioner*, 85 T.C. 237, 255–257 (1985).

In attempting to rely upon the activities of CPI and the other distributors to satisfy petitioners' burden of proving petitioner's profit objective, petitioners argue: "When determining the expertise of the taxpayer or his advisors and evaluating their efforts to exploit the investment property, the courts examine the expertise of the people in control of the investment, even if that person is the seller." Petitioners cite *Siegel v. Commissioner*, 78 T.C. 659 (1982); *Harrington v. Commissioner*, T.C. Memo. 1984–428, on appeal (3d Cir., Dec. 28, 1984); and *Reali v. Commissioner*, T.C. Memo. 1984–427, in support of their position. In those cases we did examine the expertise and efforts of independent parties, like CPI in the present case, engaged to promote and distribute the rights acquired by the taxpayers. See also sec. 1.183–2(b)(2), Income Tax Regs. That examination, however, was not our sole or even primary focus. In *Siegel*, for example, the investor partnership itself, through its general partner, engaged in substantial efforts to promote the venture[10] and remained apprised of the efforts expended and results obtained by the independent distributor.[11]

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[9] We express no opinion as to whether the income forecast method would be an appropriate method for computing depreciation with respect to "When TV Began." Nor do we attempt to resolve the dispute between the parties as to whether the method actually used by petitioners was the income forecast method.

In *Flowers v. Commissioner*, 80 T.C. 914, 932 (1983), we determined that a "passive" partnership did not possess the requisite profit objective and stated the applicable standard as follows:

> Our inquiry is [not] confined solely to the activities of the partnership, for those parties possessing resources sufficient to acquire and exploit investment property are not always blessed with corresponding expertise. In such case, a partnership can rely upon the expertise of third parties by contractually assigning most of the normal duties and responsibilities associated with the income-generating operations to such parties. The scope of the relevant inquiry therefore expands to encompass the entirety of such multilayered transactions. See *Siegel v. Commissioner, supra* at 700–702; *Brannen v. Commissioner, supra* at 509–511. *However, the profit motive issue must still be assessed from the perspective of the partnership. Thus, where the partnership is virtually passive in its operations, the prudence it exercises in acquiring property and in assigning duties to third parties, and the care with which it oversees the performance of such duties are of heightened importance.* [Fn. ref. omitted. Emphasis supplied.]

Thus petitioners cannot satisfy their burden merely by pointing to the activities of CPI, Silver Burdett, and MCP. In determining petitioner's true intention, we must, as in *Flowers*, consider the objective evidence regarding his acquisition of "When TV Began" and his oversight of the distributors. As discussed above, petitioner's acquisition of "When TV Began" exhibited almost no concern for the nontax merits of the investment. As discussed below, petitioner's conduct, or lack thereof, after the purchase further indicates his almost total focus upon tax benefits.

Through September 1984, total hard cover and soft cover sales of "When TV Began" were 4,928 copies and 8,248 copies, respectively. Assuming that all sales of the hard cover edition were direct to schools and libraries and that Silver Burdett and MCP paid all royalties due petitioner, petitioner would have received a total of $8,762,[12] before payments on the nonrecourse note to CPI. Although this amount receivable during the first 6 years of the investment is less than one-half of the average *annual* receipts projected by Collins and less than one-third of petitioner's cash investment, there exists no evidence that petitioner or Rosen contacted any of the distributors to ascertain why receipts were so low or whether efforts were being undertaken to improve the book's performance. Indeed, petitioner did not even know that CPI had engaged MCP to distribute the soft cover edition. Cf. *Elliott v. Commissioner*, 84 T.C. at 242–243. Tax motivations aside, petitioner's inaction is all the more puzzling, because each of the three distribution agreements either should have or could have been terminated for the failure to reach specified minimum unit sales or revenues.

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[10] Accord *Bizub v. Commissioner*, T.C. Memo. 1983–280.

[11] Accord *Harrington v. Commissioner*, T.C. Memo. 1984–428, on appeal (3d Cir., Dec. 28, 1984).

[12] Petitioner's receipts from hard cover sales would have been $1.53 per book (27.5 percent of $7.44 list price discounted 25 percent) or $7,540. Since "When TV Began" was 1 of the 45 titles in the $69.99 sets sold by MCP, petitioner's receipts from soft cover sales would have been $0.1482 per book (10 percent of $1.56 per title less 5-percent commission to CPI) or $1,222.

Petitioner's inaction is quite easily explainable, however, if we consider the structure of the investment and his tax motivations. Unless and until petitioner realized sufficient revenues to satisfy the $100,000 nonrecourse note, petitioner's after-tax return would actually decrease as book sales increased. Petitioners' marginal tax rates exceeded 50 percent in both 1978 and 1979, and payments to CPI on the note would, depending upon whether hard cover or soft cover copies were sold, equal 50 percent or 70 percent of the receipts, respectively. See the analysis in *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affg. *Fox v. Commissioner*, 80 T.C. 972 (1983). Ignoring interest payments on the note and assuming all sales would be of the hard cover edition, payment of the note in full would require the sale of approximately 130,720 copies of the book,[13] well in excess of the 82,000 *total* elementary schools and public libraries in the United States.[14]

Petitioner did have some, perhaps indirect, contact with CPI after his investment in "When TV Began," as he purchased two additional books. We must conclude that petitioner was a satisfied customer of CPI who received what he wanted from "When TV Began."

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[13] The sale of 130,720 copies with receipts of $1.53 per copy would yield total receipts of $200,000, 50 percent of which would pay off the note. Substantially greater unit sales of the soft cover edition would be necessary to satisfy the note. See *supra* note 12.

[14] This aspect of the investment may also explain the Dec. 15, 1978, agreement among petitioner and the four other Famous First Series investors. Instead of an attempt to diversify downside risk (i.e., the risk that one of the books would not sell as well as the others), the purpose of the agreement may have been to mitigate the above consequences if one of the books *sold better* than the others.

We do not doubt that CPI, Silver Burdett, and MCP were respected experts in the publishing industry who exerted reasonable efforts to promote and distribute "When TV Began." Indeed, all three of the distributors earned a profit with respect to "When TV Began"[15] and CPI achieved the additional objective of establishing a presence in the market with the publication of the 25 Famous First Series titles. Because of petitioner's manifest indifference to economic profit, however, we simply cannot attribute to petitioner the motivations of the distributors. See *Estate of Baron v. Commissioner*, 83 T.C. 542, 554–555, 560 (1984); *Fuchs v. Commissioner*, 83 T.C. 79, 96–97 (1984); *Dean v. Commissioner*, 83 T.C. 56, 72–73 (1984). The following statement from *Estate of Baron* is equally applicable to the present case:

> While we agree with petitioners that Casablanca [the distributor] was far more qualified than Baron to direct the promotion and sale of the album and that Baron would therefore have had very little to add to the sales campaign, we still believe that Baron's *complete* absence of contact with Casablanca can only be attributed to Baron's lack of concern with an economic profit. [83 T.C. at 560.][16]

Petitioners argue that petitioner conducted his activity with respect to "When TV Began" in a businesslike manner, as evidenced by the various agreements executed by petitioner and CPI. While we have concluded that the absence of such documentation indicated a lack of profit motive (see, e.g., *Fox v. Commissioner*, 80 T.C. at 1012), petitioners' argument exhalts form over substance to the extreme. The mere fact that petitioner and CPI signed the proper forms to establish petitioner's interest in "When TV Began" proves very little concerning his asserted profit motivation. We believe that petitioner's failure to maintain books, records, or separate bank accounts better illustrates his true objective with respect to "When TV Began." See sec. 1.183–2(b)(1), Income Tax Regs.

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[15] The $25,500 net cash received from petitioner ($30,000 less $3,000 payment to Glass and $1,500 to Rosen) plus one-half of the $3,500 advance royalty from Silver Burdett alone yielded a profit on the $23,500 investment by CPI. The sale of 4,928 hard cover copies yielded $19,936 to Silver Burdett (4,928 times $7.44 list less 25 percent times .725 to reflect 27.5 percent royalty to petitioner) from a total investment of $10,555 in "When TV Began" (4.928 copies at $.8359 per copy manufacturing cost plus 1/25 of $160,900). MCP received $519,550 from the sale of 8,248 45-book sets (8,248 times $69.99 less 10 percent royalties to book owners) from a total investment of $208,732.

[16] Petitioners assert that Rosen, as CPI's accountant, monitored the activities of the distributors but presented no evidence to support this assertion.

Petitioners contend that a number of unanticipated factors explain the ultimate lackluster performance of "When TV Began," primarily a decline in funding for public educational institutions. Cf. sec. 1.183–2(b)(6), Income Tax Regs. While several witnesses at trial verified this decline, the offering memorandum indicates that this trend had begun before petitioner purchased "When TV Began" and thus was not totally unexpected. Indeed, the reference to this trend in the offering memorandum merely represents another item about which we would expect petitioner to inquire before purchasing the book, if he were truly interested in nontax profits.

Where the taxpayer purchased an asset using nonrecourse indebtedness, we have often considered whether the fair market value of the asset approximated its purchase price in determining whether the taxpayer possessed the necessary profit objective. See, e.g., *Fox v. Commissioner*, 80 T.C. at 1009–1010; *Flowers v. Commissioner*, 80 T.C. at 937; *Siegel v. Commissioner*, 78 T.C. at 702–703; cf. sec. 1.183–2(b)(4), Income Tax Regs. We do not believe, however, that such an inquiry is particularly useful in the present case. The profit motive test requires a determination of the taxpayer's actual intent, based upon objective facts. *Dreicer v. Commissioner*, 78 T.C. 642, 645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); S. Rept. 91–552 (1969), 1969–3 C.B. 423, 489–490. Petitioner acquired "When TV Began" and supervised its publication and distribution with a manifest indifference to the book's value and profitability. Even if one knowledgeable about publishing would have considered $130,000 a fair price for "When TV Began" after a reasonable investigation, neither petitioner nor Rosen had such knowledge or conducted even a minimal investigation, despite the substantial "red flags" raised by the promotional material.

We have nevertheless considered the evidence presented with respect to the value of "When TV Began" and conclude that petitioners have failed to prove that such value approximated $130,000[17] on December 18, 1978. Petitioners argue that Collins' "appraisal" should be accepted as the best evidence of the contemporaneous value of "When TV Began." Collins projected total returns of $243,700 from the book over 12 years, although he did not estimate the specific returns each year and thus did not actually compute a value for the book.

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[17] Petitioners argue in their briefs and Rosenberg testified at trial that the true purchase price of "When TV Began" was less than $130,000, because the market interest rate for the $100,000

But the overwhelming majority of the receipts forecasted by Collins were from sources other than book sales to schools and libraries. Collins testified that he attributed significant weight to the reputation and expertise of Berner and Rosenberg, who at Random House "created * * * learning units, found whole new markets for trade books."[18] While Rosenberg testified that he estimated total returns in excess of $300,000, he provided no specific details with respect to his estimate.[19] Collins stated that his projections were consistent with the returns generated by Random House's "Landmark" series, but he offered no evidence that the Famous First Series was comparable to or could reasonably be expected to duplicate the results of Landmark. His brief testimony concerning Landmark indicated that it was a very exceptional series and that he examined the Landmark performance records "to see if the figures that Mr. Rosenberg and I were talking about were any

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nonrecourse note was greater than the stated rate of 6 percent. Petitioners' argument is inconsistent with their reporting petitioner's cost basis in "When TV Began" as $130,000 and $150,000 on their 1978 and 1979 income tax returns, respectively. The logical conclusion from petitioners' argument is thus that they did indeed engage in an overvaluation with respect to "When TV Began." In any event, petitioners presented no reliable evidence of the market rate for the note and thus of its true value.

[18] Regarding expected receipts other than from sales to schools and libraries, Collins testified as follows:

> These were the areas of markets that are nontraditional for publishers. The publishers generally do not go out and try to exploit. Book clubs to a certain extent, continuity sales, premium sales, filmstrip rights, movie and television rights.
>
> These areas most publishers because they are simply not set up to exploit these rights for a book. [sic] I probably would not even have considered at that time except Mr. Rosenberg presented those to me as a real possibility.
>
> When I learned that Mr. Rosenberg and Mr. Berner as CPI were going to act as agents for the book—
>
> Q. You mean for rights other than Silver Burdett?
>
> A. Yes, exactly.
>
> That's the second point that they had negotiated the arrangement so that those rights were retained by the owner. I firmly agreed that these markets do, indeed, exist and that they should be exploited and I had every confidence after seeing Mr. Berner and Mr. Rosenberg in performance at Random House for all of those years that they would do their utmost to exploit these markets.

[19] We accept Rosenberg's testimony that the need for immediate cash the and unavailability of conventional financing prompted CPI to sell the Famous First Series books to investors. His testimony provided no support, however, for the $300,000 estimate or a fair market value of $130,000.

resemblance to reality."[20] Moreover, we refuse to ignore that the starting points for Collins' projections were the figures prepared by Rosenberg and that Rosenberg probably influenced Collins' "appraisal."

The record thus contains no specific, objective evidence establishing the value of "When TV Began" apart from the value resulting from anticipated sales to schools and libraries.[21] Even if we ignore the effect upon value of the timing of the receipts, "When TV Began" could generate receipts of $130,000 only through the sale of approximately 85,000 hard cover copies (at $1.53 per copy, see *supra* note 12), a figure in excess of the total elementary schools and public libraries in the United States.

Based upon the testimony of both petitioners' and respondent's valuation experts at trial, we believe such market penetration extremely unlikely, particularly for a supplemental reader like "When TV Began." Edward Stern, respondent's valuation expert, estimated the value of "When TV Began" as $15,000, based upon expected sales of 10,000 hard cover copies and 20,000 soft cover copies. Randall G. Marshall, petitioners' valuation expert, valued "When TV Began" at $59,500, based upon expected sales of 56,580 hard cover copies[22] and 25,000 soft cover copies.

In summary, it is apparent that bona fide business enterprises, like CPI in the present case, may find a sideline of marketing tax benefits to provide a useful means of raising venture capital. To some extent tax incentives, such as accelerated depreciation and investment tax credit, are designed to stimulate the formation of venture capital. Such incentives are not intended, however, to create a new economy consisting of paper transactions having no relationship to the real value of goods and services. Thus, the mere presence of a valid business enterprise at some levels of a transaction does not automatically entitle passive investors distant from day-to-day operations of the enterprise to the associated tax benefits. See e.g., *Estate of Baron v. Commissioner, supra*; *Flowers v. Commissioner, supra*.

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[20] Rosenberg similarly testified that his $300,000 estimate "was the pot of revenue, if you will, that a particular title *might* be able to generate." Emphasis supplied. Such speculation is not evidence of fair market value, i.e., what a reasonably informed purchaser would pay. See *Chiu v. Commissioner*, 84 T.C. 722, 733 (1985).

[21] Berner testified as follows:

Q. And what was that sales price based on?

A. It was based upon our best estimates as to the worth of the book. That estimate was arrived at principally by our financial officer, Mr. Rosenberg. And I tested it only to the extent that I knew the library market for such a book and believed that we could make it.

Q. In other words, you did not consider personally the evaluation of what we call the "ancillary rights" but, rather, the market that Silver Burdett was going after?

A. Yes. I could not have been expert enough to —I— there are few people who can be expert enough in the ancillary rights area.

[22] Marshall computed this figure as 60 percent of the 82,000 elementary schools and public libraries in the United States plus 7,380 copies to be sold in Canada.

Based upon the entire record, we conclude that petitioner did not possess an actual and honest profit objective with respect to "When TV Began." In light of our holding on this issue, we need not decide the second issue before us. The evidence of the fair market value of "When TV Began" is nevertheless insufficient to establish the validity of the nonrecourse note. See e.g., *Estate of Baron v. Commissioner*, 83 T.C. at 551–553; *Fuchs v. Commissioner*, 83 T.C. 79, 101–102 (1984); *Dean v. Commissioner*, 83 T.C. 56, 77–78 (1984).

Decision will be entered for the respondent.

JERRY E. PRITCHETT AND PATRICIA D. PRITCHETT, ET AL.,[1] PETITIONERS V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 14586–81, 18127–81, 18128–81, 18477–81, 27413–82. Filed October 24, 1985

Petitioners were limited partners in similar oil and gas drilling partnerships. They made initial cash contributions to their respective partnerships and agreed to make future additional cash contributions if called upon to do so by the general partners in order to satisfy 15 year recourse notes executed by the partnerships in favor of a drilling company. During each year at issue, each partnership incurred a loss, and each petitioner claimed his distributive share of partnership loss in an amount which included both his actual cash contribution to the partnership, as well as his proportionate share of the partnership's note. *Held*: For purposes of sec. 465, I.R.C. (1954), each petitioner is at risk only to the extent of actual cash contribution to his partnership and not for his proportionate share of the partnership's note. Accordingly, the deduction allowable to each petitioner for his distributive share of partnership loss is limited to the amount of actual cash contribution to his partnership as of the close of the taxable year at issue.

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[1] Cases of the following petitioners are consolidated herewith: Donald R. Clifford and Joyce K. Clifford, docket No. 18127–81; Alex Indich and Mira Indich, docket No. 18128–81; Arthur Knox, docket No. 18477–81; and Richard J. Buchbinder and Voren L. Buchbinder, docket No. 27413–82.

Marc Marmaro and *Michael Constas*, for the petitioners.
Karl D. Zufelt, for the respondent.

JACOBS, *Judge*: In these consolidated cases, respondent determined the following deficiencies in petitioners' Federal income taxes:

Docket No.	*Petitioners*	*Taxable year*	*Deficiency*
14586–81	Jerry E. Pritchett and Patricia D. Pritchett	1977	$33,336
18127–81	Donald R. Clifford and Joyce K. Clifford	1977	3,270
18128–81	Alex Indich and Mira Indich	1977	30,492
18477–81	Arthur Knox	1977	7,175
27413–82	Richard J. Buchbinder and Voren L. Buchbinder	1976	11,583

The issue for decision is whether petitioners, as limited partners in five similar limited partnerships engaged in oil and gas drilling operations, are "at risk" within the purview of section 465[2] for their proportionate shares of notes given by the partnerships to a drilling company under turnkey drilling agreements. If petitioners are not at risk for their proportionate shares of these notes, then the deductions for their distributive shares of partnership losses are limited to the amounts of their cash contributions to the partnerships. If, however, petitioners are at risk for their proportionate shares of the partnership notes, then the deductions for their distributive shares of partnership losses are allowable in their entirety.

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[2] All section references are to the Internal Revenue Code of 1954 as in effect during the taxable years at issue, unless otherwise indicated.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

All petitioners resided in California when they filed their petitions. Each male petitioner[3] is a limited partner in one of five similar limited partnerships (cumulatively referred to as the partnerships). The promoters and general partners of each partnership were Albert Prager and Michael Traiger. Each partnership was formed to conduct oil and gas drilling operations. One of the partnerships (T & P, LTD.) was organized under California law in December 1976; the other four were organized under Nevada law in December 1977. The partnership in which each petitioner held an interest, the year formed, the amount of each partner's initial cash contribution thereto, and the total partnership capitalization for each of the five limited partnerships are as follows:

Petitioner	*Partnership*	*Year formed*	*Initial cash contribution to partnership*	*Total partnership capitalization*
Jerry Pritchett	Alluf, Ltd.	1977	$35,000	$412,500
Donald Clifford	Altar, Ltd.	1977	5,000	645,000
Alex Indich	Aaron, Ltd.	1977	35,000	705,000
Arthur Knox	Akiba, Ltd.	1977	5,000	465,000
Richard Buchbinder	T & P Ltd.	1976	12,500	725,000

All five partnerships engaged in drilling operations through a series of essentially identical transactions with Fairfield Drilling Corp. (Fairfield), a wholly owned subsidiary of Petroleum Development Corp. (PDC), a publicly held corporation. On December 29, 1977, Fairfield assigned to the partnerships (December 29, 1976, in the case of T & P) rights to certain oil and gas leases which it held. In exchange therefor, the partnerships agreed to pay Fairfield a royalty equal to 20 percent of the gross sales proceeds of the oil and gas extracted from the leased land, except that the royalty did not commence until the assignee-partnership received a specified amount of net profits. Concurrent with the assignment of the oil and gas leases, Fairfield and each partnership executed a turnkey drilling agreement, a completion and operation agreement, and an equipment lease agreement. As a result of these agreements, Fairfield agreed to drill and develop the leased oil and gas properties of the partnership, and to provide all necessary equipment to commercially exploit all productive wells.

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[3] The term "petitioner" and "petitioners" will exclude wives, where applicable, as only the husbands were limited partners in the partnerships involved herein.

Pursuant to the turnkey drilling agreement, each partnership paid cash and executed a recourse note to Fairfield in 1977 (1976 with respect to T & P) in amounts as follows:

Partnership	*Amount of cash*	*Amount of note*[4]	*Total*
Alluf	$412,500	$433,125	$845,625
Altar	645,000	677,250	1,322,250
Aaron	705,000	740,250	1,445,250
Akiba	465,000	488,250	953,250
T & P	725,000	761,250	1,486,250

Each note (the Fairfield note) was non-interest-bearing and had a maturity of 15 years. Each was secured by virtually all of the maker-partnership's assets. The principal for each Fairfield note was payable from the net cash available to the partnership as a result of its drilling operations. Only the general partners were personally liable under the Fairfield note; however, each limited partnership agreement (as well as the certificate of limited partnership) provided that in the event the Fairfield note was not paid in full at maturity, the limited partners of the maker-partnership would be personally obligated to make additional capital contributions to the maker-partnership sufficient to cover the deficiency once called upon by the general partners to do so.[5]

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[4] The amount of each note is exactly equal to 105 percent of the amount of cash.

[5] The certificates of limited partnership for each partnership and, with slight variations, the limited partnership agreement provided as follows:

"If there are not sufficient revenues to pay the entire principal amount of the recourse promissory drilling note by December 31, 1992, then the general partners will by written notice call for additional capital contributions in an amount sufficient to pay the outstanding balance of said promissory note. The total additional capital contributions shall be allocated among the limited partners in the proportion that the initial capital contribution of each limited partner bears to the initial capital contributions of all of the limited partners. Each limited partner shall be obligated to pay in cash to the partnership, on or before the specified due date set forth in the written notice from the general partners, given not less than thirty (30) days before such date, the amount set forth in such notice. * * *"

Four of the five petitioners testified that they believed that they would be unconditionally liable for future additional capital contributions to their respective partnerships if called upon to make

Each partnership elected to employ the accrual method of accounting and to deduct intangible drilling costs (I.D.C.) as an expense pursuant to section 1.612–4, Income Tax Regs. Accordingly, each partnership deducted the entire amount paid to Fairfield (the total of the cash and the note) under the turnkey drilling agreement in the initial year. As there was no income in that year, each partnership reported a loss equal to its entire I.D.C.[6]

The partnership agreement provided that all losses were to be allocated among the limited partners in proportion to their respective capital contributions.[7] Each petitioner deducted his distributive share of the partnership loss, as set out in the following table (which also lists their cash contributions):

Petitioner	*Distributive loss*	*Cash contribution*
Jerry Pritchett	$71,750	$35,000
Donald Clifford	10,250	5,000
Alex Indich	71,750	35,000
Arthur Knox	10,250	5,000
Richard Buchbinder	25,625	12,500

Respondent disallowed the deduction taken by each petitioner for his distributive share of the partnership loss to the extent it exceeded his cash contribution.

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such contributions by the general partners. The fifth petitioner did not testify. It is noteworthy that with respect to the four petitioners who testified, three failed to list as a liability on financial statements submitted in connection with loans the obligation to make additional capital contributions; the fourth never sought a loan and hence was not required to prepare a financial statement.

[6] The loss of each partnership in its initial taxable year was reported as follows:

Partnership	*Loss (cash and note)*
Alluf	$845,625 ($412,500 + $433,125)
Altar	1,322,250 (645,000 + 677,250)
Aaron	1,445,250 (705,000 + 740,250)
Akiba	953,250 (465,000 + 488,250)
T & P	1,486,250 (725,000 + 761,250)

[7] The limited partners were to receive 94 percent of the profits and distributions of the partnership until such time as the full amount of their original capital contributions were returned to them; thereafter, they were to receive 70 percent of the profits and distributions. Partnership distributions were to be made at such time and in such amounts as, in the sole discretion of the general partners, the business affairs and financial circumstances of the partnership permitted, provided that no distribution would be made if such would impair the financial liquidity of the partnership or would otherwise tend to render the partnership insolvent.

OPINION

The ultimate question to be resolved is whether, as a limited partner, each petitioner may deduct his entire distributive share of partnership loss for the taxable year involved, or whether the deduction is limited to petitioner's actual cash contribution to his partnership. Resolution of this question depends upon whether each petitioner is at risk on the Fairfield note.

Generally, an individual may deduct, on his own tax return, his distributive share of losses of a partnership in which he is a member. Sec. 702(a). However, there are statutory provisions that restrict the extent to which a partner may deduct his share of partnership losses. See secs. 704(b), 704(d), and 465(a). Respondent relies upon section 465 to restrict the amount of partnership loss which can be deducted by each petitioner.[8]

Section 465 was added to the Code by the Tax Reform Act of 1976, Pub. L. 94-455, 90 Stat. 1531, and is applicable to taxable years beginning after December 31, 1975. It was enacted to combat a perceived abuse which allowed a taxpayer to deduct tax losses in excess of the amount of his economic investment. S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 86.

Section 465 limits the deductibility of losses arising from certain activities, including oil and gas exploration, to the amount for which the taxpayer is at risk for such activity at the close of the taxable year. In general, a taxpayer is considered at risk for the amount of money (or basis of property) that he has contributed to the partnership, as well as amounts borrowed with respect to the activity. Sec. 465(b)(1). Section 465(b)(2) defines the term "borrowed amount" for purposes of section 465. Simply stated, as relevant to this case, a borrowed amount must both (1) be an amount borrowed for use in the oil and gas exploration, and (2) create an obligation on which the petitioner is personally liable.

A taxpayer is not considered at risk for any amount borrowed from any person with an interest in the partnership other than an interest as a creditor. Sec. 465(b)(3)(A) and (B)(i).

Respondent, contending that each petitioner was at risk only for his initial cash contribution, disallowed the deduction taken by each petitioner for his distributive share of the partnership loss to the extent it exceeded his cash contribution. Respondent first argues that neither the potential cash call nor the Fairfield notes constitute amounts borrowed within the purview of section 465. Respondent alternatively argues that, even if the Fairfield notes constitute amounts borrowed within the purview of section 465, petitioners are not at risk with regard to the Fairfield note since it represents an amount borrowed from a person[9] (Fairfield) with an interest in the partnership other than that of a creditor.

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[8] The "at risk" rules of sec. 465 override the provisions of sec. 704(d) and related provisions, including sec. 1.752-1(e), Income Tax Regs. S. Rept. 94-938 (1976), 1976-3 C.B. (Vol. 3) 49, 87.

Petitioners, on the other hand, contend that the amount for which they are at risk includes their proportionate share of the Fairfield note. The thrust of petitioners' argument is that the cash call, coupled with the recourse nature of the Fairfield note, operates to make petitioners personally liable (through liability to their respective partnerships) to Fairfield (a person who petitioners contend is without an interest in their respective partnerships) for an amount borrowed with respect to the activity. Petitioners argue that they should be considered at risk to the extent of their proportionate shares of their respective partnerships' liability to Fairfield under section 465(b)(1)(B) and (2)(A). We disagree.

The potential cash calls (even if they might be considered obligations on which petitioners are personally liable) are not amounts borrowed for use in the oil and gas exploration activity of the partnership. Hence, the potential cash calls do not satisfy the first criterion set forth in section 465 (b)(2) which defines a "borrowed amount" for purposes of section 465. On the other hand, the Fairfield notes are amounts borrowed for use in the oil and gas exploration activities of the partnerships. But they are not amounts borrowed for which the petitioners are personally liable, as determinable at the close of the taxable year at issue.

State law defines the relationship among limited partners, the partnership, and creditors of the partnership. Both California and Nevada (the two States in which the partnerships involved were formed) have adopted the Uniform Limited Partnership Act (ULPA). Ordinarily, under the ULPA, a limited partner is not personally liable for partnership obligations. Cal. Corp. Code sec. 15501 (West 1977); Nev. Rev. Stat. sec. 88.020 (1979). Therefore, generally, a limited partner is not at risk for any portion of the debt of his partnership, even if the debt is recourse. Sec. 465(b)(2)(A); see sec. 1.465-24(a)(2)(i), Proposed Income Tax Regs., 44 Fed. Reg. 32242 (June 5, 1979). Only general partners ordinarily have personal exposure with respect to the debt of a limited partnership, and therefore, ordinarily only general partners are at risk.

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[9] Sec. 7701(a) provides:

SEC 7701(a). When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) PERSON.—The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company, or corporation.

However, there may be circumstances where a limited partner would be liable for some portion of the partnership debt. The ULPA provides that a "contributor, unless he is a general partner, is not a proper party to proceedings * * * against a partnership, *except where the object is to enforce a limited partner's * * * liability to the partnership.*" (Emphasis added.) Cal. Corp. Code sec. 15526 (West 1977); Nev. Rev. Stat. sec. 88.270 (1979); see *Richard Matthews, Jr., Inc. v. Vaughn*, 91 Nev. 583, 540 P.2d 1062 (1975). A limited partner is liable to the partnership under the ULPA for (a) "the difference between the contribution as actually made and that stated in the certificate as having been made" and (b) "any unpaid contribution which he agreed in the certificate to make in the future *at the time and on the conditions stated in the certificate.*" (Emphasis added.) Cal. Corp. Code sec. 15517(1)(a) and (b) (West 1977); Nev. Rev. Stat. sec. 88.180(1)(a) and (b) (1979). Accordingly, limited partners may be named as defendants in a suit brought against the partnership by a creditor for satisfaction of a partnership debt where the limited partners are obligated to the partnership for unpaid contributions.

Petitioners posit that they are currently obligated to make future contributions to their respective partnerships. They further posit that Fairfield, as a creditor of the partnerships, could force the limited partners to satisfy this obligation to the partnership. From these premises petitioners conclude that they are personally liable to Fairfield under the Fairfield notes. The flaw in this syllogism is that petitioners are only contingently obligated to make future contributions to their respective partnerships if and when called upon by the general partner to do so. Therefore, they are not currently personally liable to Fairfield. Moreover, the cash call, as provided for in the certificates of limited partnership, is not an "unpaid contribution" which would make the limited partners personally liable under the ULPA to the partnerships in 1976 or 1977.

Each petitioner can be required to make an additional contribution to his partnership if on December 31, 1992[10], there is an unpaid balance on the Fairfield note. However, by the close of each taxable year in issue (1976 or 1977), such a requirement was merely a contingency since it was not known in 1976 or 1977 (a) whether there would or would not be sufficient partnership revenues to satisfy the Fairfield note prior to or on maturity of the note, or in the event the Fairfield note was not satisfied in full on maturity, the amount of the capital contributions needed to cover the deficiency, or (b) if the general partners would in fact exercise their discretion to make the cash call if an unpaid balance on the Fairfield note were to exist on December 31, 1992.[11] Hence, as of the close of the taxable year in issue, petitioners had no current ascertainable liability to their partnerships for future contributions.[12]

Our holding comports with the common law contract principle that a contingent debt does not reflect a present liability. A debt is an unconditional promise to pay a sum certain in money or money's worth on demand or on a specific date. As long as it is subject to a contingency, it is not a debt on which present liability has accrued. See *Gilman v. Commissioner*, 53 F.2d 47, 50 (8th Cir. 1931).

Petitioners' brief cites *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962); *Linder v. Vogue Investments, Inc.*, 239 Cal. App. 2d 338, 48 Cal. Rptr. 633 (1966); *Indiana Mortgage & Realty Investors v. Spira-Mart of Lansing*, 115 Mich. App. 141, 320 N.W.2d 320 (1982); and *Robinson v. McIntosh*, 3 E.D. Smith 221 (N.Y.C.P. 1854), to support their contention that "the Uniform Act has allowed creditors such as Fairfield to directly enforce the agreement of the limited partners of each Partnership to contribute their pro rata share of the unpaid balance of the Notes." We find petitioners' reliance upon these decisions to be misplaced.

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[10] Dec. 31, 1991, for petitioner Buchbinder.

[11] Dec. 31, 1991, for petitioner Buchbinder.

[12] The certificates of limited partnership provide for the cash call only at the stated maturity date.

Each of those cases involved limited partners who either withdrew their stated investment or were relieved from their obligation to make the total contribution to the partnership stated in the certificate, after debts had been incurred by the partnerships involved, thereby impairing the creditors' rights upon default. The cases proceeded on the theory that the assets of the partnership should be available to liquidate its debt, regardless of whether those assets are in the possession of the partnership or the partners. The creditor was permitted to pursue the party in possession; he was not hindered by a collusive act aimed at defeating his claims. See Cal. Corp. Code secs. 15516, 15517(3) and (4), and 15523 (West 1977); Nev. Rev. Stat. secs. 88.170, 88.180(3) and (4), and 88.240 (1979).

Here we are faced with no such situation. Fairfield's rights have not been impaired during the years in issue. Assuming, without deciding, that under *Donroy* and the other cases cited by petitioners, Fairfield might eventually have a direct path to petitioners in the event the partnership debt matured unsatisfied, our holding would not be altered. The "at risk" inquiry for purposes of section 465 is an annual one made on the basis of the facts existing at the end of each taxable year. S. Rept. 94-938, 1976–3 C.B. (Vol. 3) 49, 86. Before and during the years in issue there was no collusive release of the limited partners from their obligations to make future capital contributions; we need not speculate as to what might happen in some subsequent year. Thus, as of the end of each taxable year (1976 or 1977), Fairfield had no established recourse on its notes against petitioners; therefore petitioners are not liable on those notes.

In summary, we find nothing in the ULPA, as enacted or interpreted in California and Nevada, that would saddle petitioners with liability for the Fairfield note.

Petitioners have posited still an additional theory to support their contention that they are personally liable on the Fairfield note. Specifically, they argue that Fairfield is a third party beneficiary of the contract (the limited partnership agreement) between the partnerships and the limited partners to make future contributions to satisfy any outstanding principal balance on the Fairfield note, and as such, Fairfield may proceed against the limited partners directly to enforce this obligation. Petitioners contend that this satisfies the criteria of section 1559 of the California Civil Code, which provides that "A contract, made *expressly* for the benefit of a third person, may be enforced by him at any time before the parties thereto rescind it" (emphasis added). The requirement for an additional contribution by the limited partners, according to petitioners, is *expressly* designed to protect Fairfield in the event of a shortfall in the partnership assets. Therefore, they contend, Fairfield may enforce it against the limited partners.

Accepting, arguendo, petitioners' contention that the third party beneficiary doctrine as enacted by section 1559 in California applies in this situation, we nevertheless conclude that Fairfield has no recourse against the limited partners at the close of the taxable years at issue.

On the basis of the foregoing, we hold that petitioners are not personally liable for any portion of the partnership notes to Fairfield either under the ULPA or by the third party beneficiary doctrine at the close of the taxable years at issue.[13]

Having found that petitioners have no personal liability on the Fairfield note,[14] we hold that they are at risk only for the actual cash contribution made as of the close of the taxable years at issue.[15] So found, we need not address the issues involving Fairfield's interest in the activity.

To reflect the foregoing,

Decisions will be entered for the respondent.

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[13] We note sec. 1.465-22(a), Proposed Income Tax Regs., 44 Fed. Reg. 32238 (June 5, 1979), which requires as an omission from the amounts considered at risk, that sum "which the partner is required under the partnership agreement to contribute until such time as the contribution is actually made." This proposed regulation, at least as it applies to the facts with which we are here involved, comports with the general scheme of sec. 465, which is to prevent an artificial inflation of the amounts considered at risk beyond those amounts which the taxpayers actually stand to lose as of the close of the taxable year at issue.

[14] It could be argued that satisfaction of the Fairfield note will ultimately be borne by petitioners, either through a reduction of distributions from their respective partnerships or by the payment of additional capital contributions. We do not accept such argument because it ignores the fact that the obligation to Fairfield is that of the partnerships (and not of the partners) and that the limited partners are entitled to receive partnership distributions only at such times and in such amounts as the general partners determine, and only if such would not impair the partnerships' ability to satisfy their obligations.

[15] Cf. *Brand v. Commissioner*, 81 T.C. 821 (1983), where we held that a limited partner who had guaranteed a partnership obligation was not at risk on the partnership obligation.

Reviewed by the Court.

STERRETT, GOFFE, CHABOT, PARKER, SHIELDS, and CLAPP, *JJ.*, agree with the majority opinion.

GERBER, *J.*, did not participate in the consideration of this case.

SIMPSON, *J.*, concurring: I agree with the result reached by the majority. However, there are a variety of circumstances which have influenced my conclusion, and I wish to mention them.

The objective of section 465 is to limit deductions for losses to amounts at risk, and to carry out that objective, we must be assured that an amount is truly at risk. S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 86. To carry out that responsibility, we must examine all the surrounding circumstances to ferret out the true substance of the transaction. An obligation by a partner to make additional contributions does not, standing by itself, create an amount at risk since the obligation is clearly owed to a person, the partnership, having an interest in the activity. An obligation to make additional contributions can result in an amount being at risk only if that obligation is coupled with a recourse obligation by the partnership. See 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, par. 8.03, at 8–11 to 8–12, and par. 10.11[2][b], at 10–78 to 10–79 (1977); Kalish & Rosen, "The Risky Basis for Partnership Allocations," 38 Tax Lawyer 119, 140–141 (1984). Thus, to determine whether the promise by the petitioners in this case results in an amount at risk, we must inquire into the substance of the notes to Fairfield.

At the outset, it should be pointed out that those notes do not bear interest. Although they purport to call for the payment of amounts ranging from $400,000 plus to $700,000 plus in 1992, they do not create a current obligation to pay such amounts. An obligation to pay $100 in 15 years without interest is currently worth only $23 if we assume that the customary interest rate for such an obligation is 10 percent. C. Nickerson, Accounting Handbook for Nonaccountants 575 (1975). Hence, at most, the notes represent a current obligation of less than 25 percent of the stated amounts.

In addition, an amount borrowed is not considered to be at risk unless the obligation is owed to a person not having an interest (other than as a creditor) in the activity. Sec. 465(b)(3). Here, Fairfield was not disinterested in the activities of the partnerships. The partnerships acquired the oil and gas leases from Fairfield, and in addition, Fairfield and the partnerships entered into turnkey drilling agreements, completion and operation agreements, and equipment lease agreements. As a part of the transactions, Fairfield acquired a right to 20 percent of the gross sales proceeds of the oil and gas extracted from the leased lands, payable only after the partnerships had achieved certain levels of profits. These arrangements gave Fairfield a substantial interest in the activities of the partnerships.

Furthermore, the liability of the limited partners, such as the petitioners, is, by its terms, contingent upon the general partners' exercise of their right to call upon the limited partners for contributions. It is easy to imagine a situation in which the general partners might be financially irresponsible and have no interest in attempting to collect from the limited partners to satisfy the notes held by Fairfield. In such a situation, a question would arise as to whether Fairfield could enforce contributions by the limited partners. There is some authority for believing that Fairfield could enforce the obligations (Cal. Corp. Code sec. 15517(3) (West 1977); Cal. Civ. Code sec. 1559 (West 1982); *Lucas v. Hamm*, 56 Cal. 2d 583, 15 Cal. Rptr. 821, 824 (1961); *Gilbert Financial Corp. v. Steelform Contracting Co.*, 82 Cal. App. 3d 65, 145 Cal. Rptr. 448 (1978)), but it is far from a settled matter (2 Restatement, Contracts 2d, sec. 302 comment b (1979)).

In summary, the liability of the limited partners is far from clear and certain, and under such circumstances, to carry out the objective of section 465, they should be required to postpone the recognition of their losses until they actually make additional contributions. The effect of our decision is not to deny them a deduction altogether: if income of a partnership is used to pay off its note to Fairfield, each limited partner will be taxable on his distributive share of such income; but at the same time, he is treated as making an additional contribution of such share, and he will be entitled to carry over any loss not previously recognized and deduct that loss against such income. Sec. 465(a)(2); S. Rept. 94–938, *supra*, 1976–3 C.B. (Vol. 3) at 88 n. 8. If he ultimately makes additional contributions as a result of the call arrangement, he will be entitled to deduct, at that time, losses not previously allowed. Sec. 465(a)(2) and (b)(1)(A).

STERRETT, GOFFE, and SWIFT, *JJ.*, agree with this concurring opinion.

WHITAKER, *J.*, dissenting: If the facts as found support the alternative analysis posited in Judge Simpson's concurring opinion, and I am not certain that they do, then the majority may have inadvertently reached the right result, although for the wrong reasons. But I strongly disagree with the majority's deference to State law characterizations of general and limited partners, with the majority's approach to the application of section 465[1] and finally with the majority's conclusion that the liability of the limited partners is contingent. With respect to the "contingent" issue, I agree with Judge Cohen's analysis and have joined in her dissent.

Generally, under State law, it is only a limited partner whose personal liability can be confined to that amount of property which he contributed or is required to contribute to the partnership;[2] a general partner is liable for all recourse obligations of the partnership. Personal liability exposes the personal assets of the responsible person to payment of the obligation; it stands in contrast to limited liability, which exposes only the collateral pledged as security for satisfaction of the obligation.[3] Neither requires that the liability be presently payable. State law definitions envision a clear distinction as to the presence or absence of personal liability in connection with third party obligations. While State law must be applied in determining the rights and liabilities of partners to each other and to third parties, it is Federal law that controls the manner in which these rights and liabilities are to be taxed. *Lyeth v. Hoey,* 305 U.S. 188 (1938); *Helvering v. Stuart,* 317 U.S. 154 (1942). Labels, whether mandated by State law or adopted by the parties, are unimportant. This is especially true when undertaking to determine basis and applying the "at risk" rules to partners.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Cal. Corp. Code sec. 15517(1)(a) and (b) (West 1977); Nev. Rev. Stat. sec. 88.180(1)(a) and (b) (1979).

[3] In distinguishing between the characteristics of corporations and partnerships, sec. 301.7701-2(d)(1), Income Tax Regs., defines limited and personal liability as follows:

> (d) *Limited liability.*—(1) An organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of or claims against the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of such organization are insufficient to satisfy the creditor's claim. * * *

We are concerned here with Federal taxation of a limited partner who has made himself personally liable in a capacity analogous to that of a general partner with respect to a particular partnership obligation. In that situation, one commentator has suggested:

> that the courts should not attempt to pigeonhole a limited partner who is liable as a general partner into one category for all purposes of taxation, rather, they should determine the underlying congressional policy of the operative Code provision and make a de facto analysis on a case-by-case basis.[4]

From a practical as well as an economic point of view, a limited partner who has assumed a pro rata part of a partnership recourse liability is the equivalent of a general partner, especially where, as here, the general partner, with respect to the same liability, has limited his liability by the contractual call upon the limited partners.[5]

On the facts before us, both general and limited partners are personally liable for a pro rata portion of the partnership's recourse obligation to Fairfield. Being similarly situated, they should be treated equally for Federal tax purposes unless the statute compels us to do otherwise, which it does not. Consequently, to the extent that the majority opinion distinguishes between, and turns upon, State law characterizations of general and limited partners, it may be correct for State law purposes,[6] but for Federal tax purposes the majority ignores both form and substance and unduly extends section 465.

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[4] Banoff, "Tax Distinctions Between Limited and General Partners: An Operational Approach," 35 Tax L. Rev. 1, 26 (1979).

[5] For an excellent discussion of both basis and "at risk" in the partnership context, see Kalish & Rosen, "The Risky Basis for Partnership Allocations," 38 Tax Lawyer 119 (1984). In pertinent part these authors at page 133 assert that:

> "The thrust of the rules for sharing recourse liabilities is to allocate the liabilities to the partners who would be required to satisfy the liabilities out of their personal assets in the event of a default by the partnership. A limited partner who is obligated to make additional capital contributions if necessary to satisfy a recourse creditor is in precisely the same situation as a general partner with regard to the recourse creditor."

The majority's application of section 465 fails to recognize the relationship between the basis and the "at risk" provisions. Section 465 merely suspends what would otherwise be an allowable deduction. S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 86. The amount of depreciation or other deductions which a partner is permitted to take is initially limited to the amount of his basis in the partnership. Sec. 704(d). *Kingbay v. Commissioner*, 46 T.C. 147, 151 (1966). Thus, in the absence of basis, there is no deduction to suspend. A determination of basis, therefore, is a prerequisite to the application of the "at risk" provisions.

A partner's share of partnership liabilities is treated as a contribution of money by the partner to the partnership resulting in an increase in the partner's adjusted basis. Sec. 752. Each partner's share of recourse liabilities is initially determined in accordance with the ratio in which the partners share losses under the partnership agreement. Sec. 1.752–1(e), Income Tax Regs. A limited partner's share of recourse liabilities, however, may not exceed the difference between his actual contribution to the partnership and the total contribution that he is obligated to make under the limited partnership agreement. Sec. 1.752–1(e), Income Tax Regs. Consequently, a limited partner's basis in his partnership interest can be increased by his share of partnership recourse obligations to the extent that he is obligated to make additional contributions to the partnership.

At page 588, the majority states that "the cash call, as provided for in the certificates of limited partnership, is not an 'unpaid contribution' which would make the limited partners personally liable under the ULPA."[7] While there may be situations in which a contingency is so remote that an obligation lacks substance and should be ignored, this is not one of them. Under the majority's contingency analysis, the limited partners would acquire basis only when the cash call is complied with, a position contrary to the import of respondent's regulations and inconsistent with the congressional intent to allocate basis to those parties who will be required to utilize their own assets to retire partnership liabilities if the partnership incurs losses. Thus the majority suspends a deduction under section 465 which its own analysis would never have allowed the limited partners to claim under section 752. The majority should, therefore, have forced the parties to focus on basis, rather than deciding the case on an issue which, under the majority analysis, could not be reached. However, as Judge Cohen demonstrates, the limited partners do have personal liability for their respective shares of the recourse liability. Hence, the liability should be included in basis and the loss should be allowed unless otherwise suspended pursuant to section 465. For the reasons articulated by Judge Cohen, the section 465 requirements are met.

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[6] Both the majority and the concurring opinions touch upon the right of Fairfield to sue the limited partners to enforce the cash call, on the unrealistic assumption that the general partner will not make the necessary demand. The fact of the matter is that State law has not caught up with the contractual devices which partnerships have adopted since 1976 in an effort to comply with the "at risk" rules. Investors apparently have realized that assumption of a deferred obligation is more than offset by present deductions, a fact that Congress, in enacting sec. 465, either did not anticipate or, more likely, was willing to accept.

[7] For personal liability, the majority apparently would require a presently payable obligation in a fixed amount. See Tech. Advice Memo. 8404012 (Oct. 13, 1983), in which the Service takes the position that a limited partner's obligation to make additional capital contributions if the

As discussed above, the tax consequences under section 465 of transactions involving similarly situated taxpayers should be the same. If a general partner is "at risk" as to a partnership's recourse obligation by virtue of his liability, then a similarly situated limited partner should also be considered "at risk." Each party is "ultimately liable" on the obligation. See *Smith v. Commissioner*, 84 T.C. 889 (1985). Moreover, if the limited partner is not at risk for his share of the obligation, would the majority allocate that part of the debt to the general partner's basis and include it in his amount "at risk"? We think not. The Senate report and section 465(b)(3) restrict the general partner to his own pro rata part of the Fairfield note:

> A taxpayer's capital is not "at risk" in the business, * * * to the extent he is protected against economic loss of all or part of such capital by reason of an agreement or arrangement for compensation or reimbursement to him of any loss which he may suffer. Under this concept, an investor is not "at risk"

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partnership is unable to satisfy its recourse liabilities is too contingent to entitle the limited partner to include his share of the liability in his basis under sec. 1.752-1(e) of the regulations. Excluding this type of contingency from basis is contrary to the basic premise of sec. 752 and the regulations, which generally allocate recourse liabilities among the partners so as to reflect the manner in which they will share the economic burden of the liabilities if the partnership is unable to pay them.

> * * * if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person. [S. Rept. 94-938, 1976-3 C.B. (Vol. 3) 49, 87.]

Consequently, no general partner's amount "at risk" can be increased to the extent of the limited partner's cash call obligations. See *Brand v. Commissioner*, 81 T.C. 821 (1983). This could not have been Congress' intent.

The allocation of "at risk" amounts should accrue to the benefit of the partner ultimately bearing the economic risk of default. Any partner, whether general or limited, who is obligated to make good on a partnership's recourse obligation in the event of default is personally liable for purposes of the "at risk" provisions to the extent that he is not otherwise protected against loss. Each partner will be required to use his personal assets only if the partnership assets prove inadequate. The adequacy of the partnership assets, however, does not of itself constitute a contingency affecting a partner's amount "at risk." On these facts, each partner was "at risk" in an amount equal to his pro rata share of the unpaid recourse obligation as of the close of each taxable year.

I recognize that the "at risk" inquiry is an annual one on the basis of facts existing at the end of each taxable year. S. Rept. 94-938, 1976-3 C.B. (Vol. 3) 49, 86. I further recognize that at the end of each of the years in issue, the actual amount which any of these partners may be required to contribute pursuant to the cash call cannot be definitively determined. In theory, no contribution might be required. However, a partner may be personally liable on a recourse obligation which is not presently payable. As to recourse obligations, the test remains whether, and to what extent, a partner is personally liable on the obligation in the event of default.

For these reasons, I would hold that the limited partners have basis and are "at risk" to the extent of their pro rata share of the Fairfield note unless Judge Simpson's speculation should turn out to be accurate.

NIMS, KÖRNER, COHEN, and WRIGHT, *JJ.*, agree with this dissent.

HAMBLEN, *J.*, dissenting: I respectfully dissent. The Court majority, in my opinion, makes an errant approach to the problem presented. Section 465 was enacted to prevent loss deductions in excess of economic investment arising from certain tax shelter activities. The arrangement petitioners entered into appears to have substance, although the at risk value of the Fairfield note is problematical. If so, as Judge Simpson's concurring opinion relates, then we should limit the at risk value of the Fairfield note rather than extend the at risk provisions to situations where cash call requirements within the partnership agreement present additional economic risk to limited partners.

Furthermore, I share Judge Simpson's view, and that of Judge Cohen, that the Court's "at risk" analysis, as applied here, should be firmly focused on and limited to Fairfield's role in the transaction as a person having an interest in the activity other than that of a creditor. Sec. 465(b)(3). The majority approach which focuses on the partnership agreement cash call requirements creates a bad precedent for genuine business transactions structured through limited partnership arrangements. See 1 W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners, par. 8.03, at 8–11 to 8–12 and par. 10.11 [2][b], at 10–78 to 10–79 (1977). It is my view that the limited partners here were on par with general partners as far as liability on the Fairfield note is concerned. I, therefore, concur with Judge Cohen's dissent.

NIMS, WHITAKER, COHEN, and WRIGHT, *JJ.*, agree with this dissent.

COHEN, *J.*, dissenting: I respectfully dissent. As Judge Whitaker states, the issue is one of Federal tax law. Although we may look to State law to determine the substantive rights and liabilities of the various parties to the transactions, in my view the majority focuses excessively upon the purported uncertainty of creditors' remedies under California law.

The result reached by the majority may indeed be correct on the facts. I share Judge Simpson's impression that Fairfield appears to be a person having an interest in the activity, other than that of a creditor, under section 465(b)(3), and that the absence of a provision for interest on the notes adds an element of economic unreality to the transactions. This should be explored further by the finder of facts. I cannot, however, join the majority's reasoning that the liability of the limited partners on the notes to Fairfield is "contingent" for the purpose of the "at risk" rules.

The majority cites two reasons for its conclusion at page 588:

> the requirement [to make an additional capital contribution] was merely a contingency since it was not known in 1976 or 1977 (a) whether there would or would not be sufficient partnership revenues to satisfy the Fairfield note prior to or on maturity of the note, or in the event the Fairfield note was not satisfied in full on maturity, the amount of the capital contributions needed to cover the deficiency, or (b) if the general partners would in fact exercise their discretion to make the cash call if an unpaid balance on the Fairfield note were to exist on December 31, 1992. * * *

I agree that the second contingency, if it existed, might ultimately negate the liability of the limited partners to make the cash call; in that event, they would not be at risk on the liability to Fairfield. Nowhere does the majority find, however, that the general partners had the unilateral discretion to waive the express undertaking of the limited partners to make the additional contributions if the notes were not satisfied through partnership operations by the maturity date. Such a result would indeed be anomalous as a matter of State law. The references to State law in the majority opinion strongly suggest, and indeed the entire opinion implies, that Fairfield could, at maturity, force the limited partners to make the additional contributions to satisfy the notes.

Thus the determinative "contingency" found by the majority can only be that the partnerships might generate sufficient revenues to satisfy, in full or in part, the notes to Fairfield prior to their maturity date. Whether this possibility renders petitioners' liability "contingent" can best be examined by assuming for a moment that such "contingency" did not exist, i.e., that the notes to Fairfield merely required a single balloon payment on the maturity date and that cash from partnership operations was currently distributable to the partners. Under this assumed scenario, the limited partners' obligations to contribute the additional funds and thereby satisfy the notes on maturity would be certain: the possibility that interim partnership revenues could discharge that liability would not exist.

The "contingency" relied upon by the majority is thus merely the *acceleration of payment on the notes*, as compared with the posited scenario. If the limited partners are not considered at risk solely because of such "contingency," it is doubtful that any liability could pass muster under section 465. Any indebtedness might be satisfied through cash generated by the leveraged activity or asset. Bona fide investors incurring valid, recourse debt typically hope such will be the case. Section 465(b)(2), however, specifically contemplates that certain borrowed amounts are to be included as amounts at risk.

In enacting the rules under examination, Congress intended to prevent a taxpayer from deducting an amount for which he is not at economic risk. S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 85. The paradigm situation to which the "at risk" rules apply is where the investor incurs nonrecourse debt, on which he has no personal liability and will suffer no economic detriment if the activity generates insufficient revenues to satisfy the debt. S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 87–88. The majority thus distorts and unduly extends the "at risk" rules. Instead of limiting the taxpayer's deduction where the liability is payable *only* out of revenues generated by or assets used in the activity, the majority extends section 465 to situations where the liability *may* be so paid. As the term is used by Congress, whether an investor is *at risk* depends upon the nature of the taxpayer's obligation if the activity is an economic failure, not if it is a success.

The majority apparently attributes significance to the general partners' discretion over distributions to the limited partners. (See note 14.) Because the partnership agreements prescribed specific ratios for partnership distributions, however, the discretion of the general partners merely related to the timing of the distributions. It is incongruous that the possibility that funds would remain in the partnership and not be distributed immediately to the limited partners could render the limited partners not at risk. Distributions from a partnership *reduce* a partner's initial amount at risk. Sec. 7.465–2, –5, Income Tax Regs.; S. Rept. 94–938 (1976), 1976–3 C.B. (Vol. 3) 49, 89.

The majority states that the limited partners were not liable on the Fairfield notes as of the years in issue because "Fairfield had no established recourse on its notes against petitioners." (Page 589.) This statement confuses the existence of liability with the timing of payment thereon and the means of enforcing such payment. A taxpayer who must make payments on a debt on or before the maturity date has personal liability, and hence is at risk, even though the creditor cannot enforce payment before maturity.

Congress could have prescribed the result reached by the majority by prohibiting deductions with respect to all indebtedness, recourse and nonrecourse alike, or by dealing with various types of debt in greater detail. As we have so frequently said, however, it is not for us to rewrite the statute as enacted.

WILBUR, NIMS, WHITAKER, KÖRNER, and HAMBLEN, *JJ.*, agree with this dissent.

FARMERS COOPERATIVE COMPANY (SUCCESSOR-IN-NAME TO FARMERS CO-OP OIL COMPANY), PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

FARMERS COOPERATIVE SOCIETY, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 15643–82, 5988–83. Filed October 24, 1985.

Petitioners were tax-exempt farmers' cooperatives that had been granted exempt status in 1929 and 1956. Each petitioner was audited for 2 years during the period 1977 through 1980. Respondent determined that both petitioners failed to meet the requirement of sec. 521, I.R.C. 1954, that substantially all of the capital stock be owned by producers who market products or purchase supplies and equipment through the cooperatives. Respondent's determination to revoke tax-exempt status was predicated upon an 85-percent minimum threshold for the "substantially all" requirement of sec. 521(b)(2), I.R.C. 1954. *Held*, the 8th circuit's approval of respondent's 85-percent test in *West Central Cooperative v. United States*, 758 F.2d 1269 (8th Cir. 1985), affg. per curiam an unreported District Court opinion, followed in this case. *Held, further*, although the facts of this case warrant application of the 85-percent test, that

standard may not be appropriate in all factual contexts and may be too inflexible to fulfill congressional intent underlying the inactment of sec. 521, I.R.C. 1954.

Richard S. Wheeler and *Stanley W. Rosenkranz*, for the petitioners.

Ruud L. DuVall, for the respondent.

GERBER, *Judge*:[*] In these consolidated cases, respondent determined deficiencies in petitioners' Federal income taxes as follows:

Docket No.	*Petitioner*	*Year*	*Deficiency*
15643–82	Farmers Cooperative Co.	[1]1977	$2,934.94
		1978	891.47
5988–83	Farmers Cooperative Society	[2]1979	12,638.23
		1980	10,695.18

The issue for our consideration is whether petitioners are exempt cooperative associations under section 521[3] because

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[*] By order of the Chief Judge, this case was reassigned from Judge Theodore Tannenwald, Jr., to Judge Joel Gerber for disposition.

[1] Respondent initially characterized the grain storage income received by Farmers Cooperative Co. (company) in 1977 and 1978 as non-patronage-sourced income. Pursuant to revocation of the company's exemption, respondent disallowed the amount of the company's patronage dividend deduction which represented a distribution of the "non-patronage-sourced" income to its patrons. Respondent has conceded, however, that all of the company's grain storage income was patronage-sourced income and therefore deductible.

[2] Respondent has conceded that he erroneously disallowed $3,070.01 of the total patronage dividend deduction claimed by Farmers Cooperative Society (society) for its 1979 tax year. Respondent originally determined that the society's patronage dividends were made in the form of nonqualified, rather than qualified, written notices of allocation. While one of the definitional requirements for a qualified written notice of allocation is that the recipient patron must have consented to take the face amount of such notice into account in computing his own income (sec. 1388(c)(1), I.R.C. 1954 as amended), respondent overlooked the fact that the society, prior to transacting any business with the recipient patrons, obtained such consent in one of the three permissible types of consent under sec. 1388(c)(2)(A), I.R.C. 1954 as amended. Accordingly, the deficiency amount for 1979 and 1980 will require recomputation. If we find for respondent on any issue, a decision will be entered under Rule 155, Tax Court Rules of Practice and Procedure.

[3] All statutory references are to the Internal Revenue Code of 1954 as amended and in effect for the taxable years at issue, unless otherwise indicated.

"Exempt" in this context is somewhat different from its use in sec. 501 because farmers' cooperatives which meet the requirements set out in sec. 521 are subject to the normal tax, surtax, and alternative tax imposed upon corporations in general by sec. 11, except that in computing taxable income they are given the advantage of deductions which are not shared by cooperatives that do not meet the requirements (sec. 1381). While all cooperatives, whether exempt or nonexempt, are entitled to deduct amounts paid or allocated to their patrons (i.e., patronage dividends) (secs. 1382 and 1388), exempt cooperatives may also deduct (1) amounts paid as "substantially all of the capital stock" of each petitioner "is owned by producers who market their products or purchase their supplies and equipment through" the respective petitioners as described in section 521(b)(2).

FINDINGS OF FACT

All of the facts have been stipulated and are found accordingly. The stipulation of facts, second stipulation of facts, and attached exhibits are incorporated herein by this reference.

Farmers Cooperative Co.

Petitioner Farmers Cooperative Co. (company) is a cooperative incorporated under the laws of the State of Nebraska with its principal office in Platte Center, Nebraska. The company's fiscal year ends on September 30 each year. Utilizing the accrual method of accounting, the company filed Federal income tax returns for fiscal years ended September 30, 1977 and 1978, on Forms 990-C (Exempt Cooperative Association Income Tax Returns) with the Internal Revenue Service Center, Exempt Organizations Section, Cornwells Heights, Pennsylvania.

The company is a farmers' association organized and operated on a cooperative basis. Its purpose is to market the products of its members or other producers and remit to them the proceeds of sales less necessary marketing expenses on the basis of either the quantity or the value of the products furnished by them. The principal products are corn, milo, wheat, soybeans, and oats. The cooperative also purchases supplies and equipment for resale to its members or other persons. Such supplies and equipment are sold at actual cost plus operating expenses. The supplies and equipment principally involve fertilizer, agricultural chemicals, fuel, oil, tires, and equipment such as sprayers, tillage equipment, and grain wagons.

The company is a capital stock company. During 1977 and 1978, the company's authorized capital stock consisted of

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dividends on capital stock and (2) amounts paid out of earnings from nonpatronage sources (sec. 1382(c)(1) and (2)). Thus, if a cooperative is exempt, such amounts are deductible regardless of whether they are paid out of patronage-sourced or non-patronage-sourced income. Secs. 1382(c)(2)(A) and 1388(a)(3). If a cooperative is not exempt, however, such amounts are deductible only if paid out of patronage-sourced income. Sec. 1388(a)(3).

40,000 shares of $12.50 par value common stock. Each shareholder was entitled to only one vote regardless of the number of shares owned.

In addition to its capital stock, the company carried evidences of ownership interest known as certificates of participation and equity credits on its books. Such forms of ownership did not entitle the holder to vote or otherwise participate in the management of the company's affairs.

During and after the 2 tax years in issue, the company's board of directors limited the ownership of its common stock to eligible persons[4] and regularly took action to purge nonpatronizing stockholders from its list of active, voting members. For example, the company's bylaws provided a procedure for recalling stock from persons who had ceased to be eligible shareholders because (1) they moved from the company's trade territory, (2) they failed to patronize the company for a one-year period, (3) they had died, or (4) they voluntarily withdrew from membership. The company does not require its patrons or shareholders to enter into membership agreements which require them to transact any particular annual quantity of their marketing or purchasing business with the company.

As of September 30, 1977, 670 producers held at least 1 share of the company's voting stock, 568 of whom (or 84.78 percent of the total) transacted business with the company during that year, by either marketing agricultural products through the company, purchasing agricultural supplies and equipment from the company, or a combination of the two. In addition, 32 producers began patronizing the company during its 1977 fiscal year and, during the course of that year, met all the qualifications to become shareholders of the company. The company's board of directors caused 31 of these 32 new members to receive 1 share of the company's stock issued on January 31, 1978, the day of the company's annual stockholders' meeting for its 1977 fiscal year.

Of the company's 102 voting shareholders who did not transact any business with the company during its 1977 fiscal year, only one shareholder had his stock either converted to nonvoting status or redeemed within 12 months after the end of the company's 1977 fiscal year. Cumulatively, the company either converted or redeemed two shareholders' stock within 18 months, 67 shareholders' stock within 24 months, and 75 shareholders' stock within 36 months, after the end of the company's 1977 fiscal year.

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[4] The company's articles of incorporation and bylaws provided in pertinent part:

"Only producers of agricultural products, including lessors and landlords in share tenancies and farmers within the trade territory of this cooperative corporation, *who do business with the corporation annually*, may own the common stock of this cooperative. [Emphasis added.]"

During the tax years in issue, the company owned and operated a facility for the receipt, handling, drying, and storage of grain produced by its patrons. This facility was licensed by the State of Nebraska as a grain storage warehouse having a capacity of 963,000 bushels. The total amount of grain handled by the company in any given year depended upon a number of variables. Accordingly, its storage facility did not always have sufficient capacity to handle all the grain produced by all its patrons in any given year.

The company's patrons delivered their grain to the company's elevator facility, at which time the grain was weighed, dried (if necessary), and placed in storage. Unless the patron had made a prior contractual arrangement with the company to deliver his grain for immediate sale, the patron had a period of time after the date of delivery to decide whether to sell the grain to the company or leave the grain in "open storage." A patron was not credited with patronage on the date he delivered the grain to the company but, rather, on the date the grain was sold. If on delivery, the patron placed the grain in open storage, the company accrued storage fees on its books, which it collected from the patron at the time the grain was sold. Only shareholders or those in the process of becoming shareholders were permitted to deliver grain to the company for storage. During its 1977 fiscal year, the company received grain storage fees in the amount of $66,643.80, which it classified as patronage-sourced income on its 1977 tax return. These grain storage fees were paid to the company by its member-patrons (i.e., not by nonmembers) and only such member-patrons (not the company) held title to the grain stored.

As of September 30, 1978, 698 producers held at least 1 share of the company's voting stock. Of this number, 576 (or 82.52 percent of the total) transacted business with the company during that year by either marketing agricultural products through the company or purchasing agricultural supplies and equipment from the company, or a combination of the two. In addition, 33 producers began patronizing the company during its 1978 fiscal year and, during the course of that year, met all the qualifications to become shareholders of the company. The company's board of directors caused 1 share of the company's stock to be issued to 31 of the 33 new members as follows: (1) 1 on March 14, 1979; (2) 29 on March 15, 1979; and (3) 1 on September 18, 1981.

Of the company's 122 voting shareholders who did not transact any business with the company during its 1978 fiscal year, 4 had their stock either converted to nonvoting status or redeemed within 6 months after the end of the company's 1978 fiscal year. Cumulatively, the company either converted or redeemed 93 shareholders' stock within 12 months, 95 shareholders's stock within 18 months, 102 shareholders' stock within 24 months, and 117 shareholders' stock within 36 months after the end of the company's 1978 fiscal year.

During its 1978 fiscal year, the company received grain storage fees in the amount of $70,751.50 which it classified as patronage-sourced income on its 1978 tax return. Of these grain storage fees, $68,998.61 was paid to the company by its member-patrons (not by nonmembers) who held title to the grain stored, with the remaining $1,752.89 paid by Commodity Credit Corp.

The Internal Revenue Service recognized the company as an exempt cooperative association under section 521 beginning April 24, 1956. On March 31, 1982, however, the District Director of the Internal Revenue Service at St. Louis, Missouri, notified the company of respondent's determination to revoke the company's section 521 exemption for all tax years beginning on or after October 1, 1976. Respondent determined that the company had "not sufficiently limited the ownership of its common stock to active producers to meet the requirements of section 521(b)(2)." Respondent revoked the company's exemption after the company requested respondent (1) to apply the 85-percent test thus allowing the company a 2-year period of "lead time" after the close of its taxable year, to recall and cancel stock held by ineligible shareholders, and (2) to recognize and give effect to the company's cancellation of the voting privileges of ineligible shareholders prior to cancelling their stock.

Farmers Cooperative Society

Petitioner Farmers Cooperative Society (society) is a cooperative incorporated under the laws of the State of Iowa with its principal office in Sioux Center, Iowa. The society's fiscal year ends November 30 each year. Utilizing the accrual method of accounting, the society filed Federal income tax returns for the 2 tax years at issue on Forms 990-C (Exempt Cooperative Association Income Tax Returns) with the Internal Revenue Service Center at Kansas City, Missouri.

The society is a farmers' association organized and operated on a cooperative basis. Its purpose is to market the products of its members or other producers and remit to them the proceeds of the sales less necessary marketing expenses on the basis of either the quantity or the valve of the products furnished by them. The products are principally grain and hogs. The society also purchases supplies and equipment for the use of its members or other persons, and turns such supplies and equipment over to them at actual cost plus necessary expenses. The supplies and equipment are principally feed, seed, fertilizer, agricultural chemicals, and lumber products.

The society's authorized stock during 1979 and 1980 consisted of 40,000 shares of $10 par value common stock. The society limited ownership of its capital stock to eligible persons.[5] Each shareholder was entitled to one vote regardless of the number of shares owned. The society issued two classes of common stock: voting and nonvoting. Only agricultural producers could own shares of the society's voting stock. Nonagricultural patrons of the society (such as townspeople, college professors and administrators, housewives, etc. who patronized the society's farm and home center or its lumberyards) were issued nonvoting stock.

A nonmember could become a member and shareholder in one of two ways. First, the nonmember could purchase a share of the society's stock by paying the $10 membership fee. The society determines whether such person is an agricultural producer, in which case a share of voting common stock is issued, or a nonproducer, in which case a share of nonvoting common stock is issued. Shares of stock can be purchased at any time during the course of the society's fiscal year. Second, a nonmember can choose not to purchase a share of stock, but rather earn it by patronizing the society. In that case, the society cannot issue the share of stock until after the end of its fiscal year, at which time it determines whether such person had sufficient patronage to earn a share of stock. The society's bylaws provide that if a nonmember fails to do sufficient business to earn a share of stock, he may contribute the balance in cash and receive a share of stock.

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[5] The society's articles of incorporation provided:

"The ownership of the capital stock of the corporation shall be limited to individual farmers, persons deriving income from their farms, or corporations engaged primarily in farming operations, substantially all of whose stockholders, officers and directors are farmers or share in the productivity of the farm."

The society's board of directors regularly took action to control the transfer of its stock by shareholders thus insuring that only producers held its voting stock. For example, the society would redeem a member's share of stock or convert a voting shareholder's stock to nonvoting status if a voting shareholder moved out of the society's trade territory, or failed to patronize the society for a period of 2 consecutive years. The shareholders were given the option of having their shares redeemed in cash or converted to nonvoting shares. If a shareholder did not respond within a reasonable period of time, his voting stock was converted to nonvoting status.

The society's articles of incorporation and bylaws prohibited shareholders from transferring their shares without the society's board of directors' consent.[6] When a share was transferred to a nonproducer it was converted to nonvoting status. The bylaws also provided a means for shareholders to voluntarily withdraw from membership. In addition, the society, based on the required credit application of each membership applicant, determined whether that person was a producer or a nonproducer. Voting stock was issued to producers only.

From its books and records, the society could distinguish between business transacted with or for member-patrons, and business transacted with or for nonmembers. The society maintained a record of all transactions (even though insignificant) and patronage dividends were paid on all accounts, no matter how small. The society was unable to determine from its records whether a patron was transacting more or less than 50 percent (or any other percentage) of his total marketing or purchasing business with the society during the year.

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[6] The society's articles of incorporation also contained the following provision for recalling stock from persons who ceased to be eligible or desirable as shareholders of the society:

"Any stockholder who ceases to be a cooperator, or becomes an undesirable stockholder in the opinion of the Board of Directors, may be expelled as a stockholder member, upon a two-thirds vote of the Board of Directors, whereupon said stockholder shall surrender his certificate and shall receive [in] full payment therefor the par value of such certificate."

As of November 30, 1979, 5,158 persons held at least 1 share of the society's capital stock which includes both voting and nonvoting shareholders. Of these shareholders, 3,580 held voting shares, 2,849 of whom (or 79.58 percent of the total) transacted business with the society during that year, either by marketing agricultural products of the society or purchasing agricultural supplies and equipment from the society, or a combination of the two. As of the same date, 1,578 held nonvoting shares with 885 (or 56.08 percent of the total) transacting business with the society during that year by purchasing supplies and equipment from the society.

Of the society's voting shareholders who did not transact any business with the society during its 1979 fiscal year, 104 shareholders had their stock redeemed within 12 months after the end of the society's 1979 fiscal year. The society redeemed, in the cumulative, 190 shareholders' stock within 18 months, 221 shareholders' stock within 24 months, 283 shareholders' stock within 30 months, and 329 within 36 months after the end of the society's 1979 fiscal year.

As of November 30, 1980, 5,552 persons held at least 1 share of the society's capital stock which includes both voting and nonvoting shareholders. Approximately 3,734 shareholders held voting shares, 2,864 of whom (or 76.70 percent of the total) transacted business with the society during that year. Of the 1,818 nonvoting shareholders, 1,012 (or 55.67 percent of the total) transacted business with the society during that year by purchasing supplies and equipment from the society.

Of the society's voting shareholders who did not transact any business with the society during its 1980 fiscal year, 117 shareholders had their stock redeemed within 12 months after the end of the society's 1980 fiscal year. The society redeemed, in the cumulative, 179 shareholders' stock within 18 months, 225 shareholders' stock within 24 months, 263 shareholders' stock within 30 months, and 292 shareholders' stock within 36 months after the end of the society's 1980 fiscal year.

Beginning September 17, 1929, the society was recognized as an exempt cooperative association under section 521 and predecessor statutes. However, on March 8, 1979, the District Director of the Internal Revenue Service Center at St. Louis, Missouri, notified the society of respondent's determination to revoke the society's section 521 exemption effective for all tax years beginning on or after December 1, 1972. Using a "random sampling to determine the amount of stock held by producers," respondent, in revoking the society's exemption, determined that the society "did not comply with the stock ownership requirements" of section 521(b)(2).

OPINION

The general question for consideration is whether petitioners are exempt cooperatives under section 521. Section 521 provides that certain farmer cooperative organizations are exempt from taxation.[7] With respect to cooperatives that issue stock, in order for the cooperative to be exempt[8] "substantially all" of the capital stock must be owned by producers[9] who market their products or purchase their supplies and equipment through the cooperative. Sec. 521(b)(2). In addition, the farmers' cooperative must demonstrate that the ownership of its capital stock has been restricted "as far as possible." Sec. 1.521-1(a)(2), Income Tax Regs.

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[7] Sec. 521(b) provides:

(1) EXEMPT FARMERS' COOPERATIVES.—The farmers' cooperatives exempt from taxation to the extent provided in subsection (a) are farmers', fruit growers', or like associations organized and operated on a cooperative basis (A) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (B) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses.

(2) ORGANIZATIONS HAVING CAPITAL STOCK.—Exemption shall not be denied any such association because it has capital stock, if * * * and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association.

[8] The "substantially all" test does not apply to nonvoting preferred stock if the owners of the stock are not entitled or permitted to participate, either directly or indirectly, in the profits of the cooperative beyond the fixed dividends. Sec. 1.521-1(a)(2), Income Tax Regs.

[9] A "producer" is a person who bears the risks of agricultural production and who cultivates, operates, or manages a farm, i.e., one who is engaged in the business of farming. Rev. Rul. 67-422, 1967-2 C.B. 217, as amplified, Rev. Rul. 72-589, 1972-2 C.B. 282. Examples of "producers" are farmers, landlords in share tenancy, or tenant farmers. See sec. 175(a) and sec. 1.175-3, Income Tax Regs. On the other hand, a "nonproducer" is one who is not engaged in the business of farming but who may have acquired agricultural commodities by other means, such as sale or exchange.

The term "substantially all" as used in section 521 is not defined in that statute or the underlying regulations. We have held, however, that 91 percent satisfies the "substantially all" requirement (*Farmers Co-Operative Creamery v. Commissioner*, 21 B.T.A. 265, 269 (1930)), while neither 78 percent nor 72 percent satisfies the requirement. *Co-Operative Grain & Supply Co. v. Commissioner*, T.C. Memo. 1973-164, on remand 407 F.2d 1158 (8th Cir. 1969), revg. in part and remanding T.C. Memo. 1967-132; *Petaluma Co-Operative Creamery v. Commissioner*, 52 T.C. 457, 465 (1969). The Commissioner has published the position that the "substantially all" test is considered to have been satisfied if at least 85 percent of such capital stock is held by producers. Rev. Rul. 73-248, 1973-1 C.B. 295.[10]

In addition, this Court (*Co-Operative Grain & Supply Co. v. Commissioner*, T.C. Memo. 1973-164) and the eighth circuit (*Co-Operative Grain & Supply Co. v. Commissioner*, 407 F.2d at 1162) have interpreted section 521(b)(2) to require that "substantially all" of a stock cooperative's shareholders not only be producers, but also be current and active patrons. While neither Court quantified this current patronage concept by defining what amount or quantity of business a producer-shareholder must transact with the cooperative in order to qualify as a current and active patron, the Commissioner has issued Rev. Proc. 73-39, 1973-2 C.B. 502, that attempts to define the quantum of business required.

The revenue procedure provides that a patron is a current and active patron *only if* he markets through that cooperative each year "more than 50 percent" of the products he produces and markets, *or only if* he purchases through that cooperative each year "more than 50 percent" of the supplies and equipment he purchases of the type handled by that cooperative. 1973-2 C.B. at 502-503. However, a person could be considered a current and active patron if, under all the facts and circumstances of his particular case, it was determined that he was unable to comply. 1973-2 C.B. at 503.

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[10] The Commissioner apparently issued Rev. Rul. 73-248, 1973-1 C.B. 295, in light of the Eighth Circuit Court's mandate to issue guidance in this area. *Co-Operative Grain & Supply Co. v. Commissioner*, 407 F.2d 1158, 1164 (8th Cir. 1969). It should also be noted that the Commissioner published the 85-percent test in a ruling at least 4 years prior to the first reporting year involved in these consolidated cases.

This is the first case where we have been asked to draw a bright line as to what percentage of stock ownership will satisfy the "substantially all" test of section 521(b)(2). Respondent, relying on the two administrative interpretations of the "substantially all" requirement, argues that petitioners are not exempt under section 521(b)(2) because "substantially all" of the capital stock is not "owned by producers who market their products or purchase their supplies and equipment through" the respective petitioner. Petitioners, on the other hand, argue that no court has decided exactly what percentage of stock ownership by such producers is sufficient in all cases to constitute compliance. In order to determine whether petitioners are exempt cooperatives under section 521(b)(2), we must address each respective test in turn.

A. 85-Percent-of-Stock-Held-by-Producers Test

Petitioners have asked this Court to determine exactly what percentage of stock ownership will be sufficient. Petitioners argue that respondent's attempt to quantify the "substantially all" test plainly ignores this Court's prior holdings and, more fundamentally, contradicts the respondent's own regulations that impose the only additional mandate that the farmers cooperative must restrict ownership of the stock "as far as possible" to actual producers. Sec. 1.521-1(a)(2), Income Tax Regs. Thus, we are asked to determine whether the "substantially all" test has been satisfied based upon a factual weighing and balancing of all the factors to determine whether the cooperative has restricted the ownership of the stock as far as possible and not on a mechanical or quantitative test.

Petitioners contend that a quantitative test ignores this Court's opinions in both *Co-Operative Grain & Supply Co. v. Commissioner, supra*, and *Petaluma Co-Operative Creamery v. Commissioner, supra* at 465, where we stated that it was not necessary to determine what percentage would constitute compliance. Therefore, according to petitioners, this Court has not, nor should it now, hold that a mechanical, quantitative test is the appropriate standard to determine whether the "substantially all" requirement is satisfied. Rather, petitioners argue, determining what constitutes "substantially all" is essentially a question of fact, depending on the particular circumstances of each case. Accord *Farmers Co-Operative Creamery v. Commissioner, supra*; *Farmers' Co-Operative Milk Co. v. Commissioner*, 9 B.T.A. 696 (1927).

Respondent, on the other hand, argues that the 85-percent test embodied in Rev. Rul. 73-248, *supra*, is a reasonable interpretation of section 521(b)(2). Respondent relies in his brief upon an unreported District Court opinion in *West Central Cooperative v. United States*, No. 1C 81-3029 (N.D. Iowa 1983). In that case, the taxpayers appealed after the District Court found that the 85-percent test is reasonable and in keeping with the congressional mandate embodied in the language of section 521(b)(2) (citing *United States v. Correll*, 389 U.S. 299, 307 (1967)). Based on the 85-percent test, the District Court concluded that the cooperative did not qualify for exemption because only 83.75 percent of the cooperative's shareholders were producers who marketed some of their products or purchased some of their supplies and equipment through the cooperative. Since the briefs in this case were filed, the Eighth Circuit Court of Appeals affirmed the District Court's opinion and conclusion that the 85-percent test in Rev. Rul. 73-248, *supra*, is a reasonable interpretation. *West Central Cooperative v. United States*, 758 F.2d 1269 (8th Cir. 1985), affg. per curiam an unreported District Court opinion. Because an appeal in these consolidated cases lies in the eighth circuit, we are bound by the eighth circuit's affirmation that the 85-percent test is reasonable. *Golsen v. Commissioner*, 54 T.C. 742, 756–758 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971).

Nevertheless, we agree in concept with the Internal Revenue Service's 85-percent test and find it an appropriate measure in light of various court opinions interpreting the "substantially all" language of section 521(b)(2). Prior to the eighth circuit's affirmance of the holding that 83.75 percent does not satisfy the "substantially all" requirement, the highest percentage found to be less than "substantially all" was 78 percent (*Co-Operative Grain & Supply Co. v. Commissioner, supra*), while 91 percent was the lowest amount held to constitute "substantially all" (*Farmers Co-Operative Creamery v. Commissioner, supra* at 269). Based upon the 85-percent test, petitioners do not qualify for exemption because only 84.78

percent of the company's producers in fiscal year 1977 and only 82.52 percent in fiscal year 1978 transacted business with the company. The figures are less favorable with respect to the society; 79.58 percent of the society's producers in fiscal year 1979 and 76.70 percent in fiscal year 1980 transacted business with the society.

The favorable tax treatment afforded cooperatives is intended to benefit the member-producers, not the cooperative as a business entity. *Co-Operative Grain & Supply Co. v Commissioner*, 407 F.2d at 1163. That policy focus provides a reason, if not a compulsion, to strictly construe the "active participation" and "substantially all" requirements of the statute. Tax statutes permitting special exemption are to be strictly construed against the taxpayer. *Helvering v. Northwest Steel Rolling Mills, Inc.*, 311 U.S. 46 (1940); *Luehrmann's Estate v. Commissioner*, 287 F.2d 10 (8th Cir. 1961). Accord (with respect to cooperatives seeking exemption under section 521) *Land O'Lakes, Inc. v. United States*, 514 F.2d 134, 139 (8th Cir. 1975), cert. denied 423 U.S. 926 (1975); *Co-Operative Grain & Supply Co. v. Commissioner*, 407 F.2d at 1162; *Farmers Union Co-Op. Co. v. Commissioner*, 90 F.2d 488, 493 (8th Cir. 1937). In ordinary usage or specialized tax parlance, 85 percent is an appropriate and possibly a liberal meaning of "substantially all," considering the policy objectives of the statute. In other areas of the Code dealing with an exemption from taxation, for example, in the tax-exempt bond area, the regulations contain a 90-percent "substantially all" test with respect to the use of proceeds of bonds issued to provide for certain facilities. Sec. 1.103–8(a)(i), Income Tax Regs. Accordingly, we are in agreement with the recent judicial approval of the 85-percent standard for stock cooperatives. *West Central Cooperative v. United States, supra.*

We do not believe, however, that the eighth circuit intended to support or fashion a rigid standard which would, under all circumstances, not achieve the congressional intent of the statute. If, for example, a cooperative had 90 percent of its shareholders patronize the cooperative for 3 successive years and then shareholder participation dropped to 84.75 percent for 1 year, the congressional intent would not be served by revoking the cooperative's exempt status for the year that participation fell below 85 percent. In such a situation, the cooperative has not become the focal point or reason for its own existence, thereby being transformed into a business enterprise separate from its shareholders or members. Accordingly, we believe the cooperative would have satisfied the "substantially all" requirement. On the other hand, a cooperative with 78 percent patronization for 3 successive years, and then 84.75 percent for 1 year, does not comply with the "substantially all" test and has not restricted the ownership of its capital stock "as far as possible" to active shareholders. To that extent, we agree with petitioners that a facts-and-circumstances approach should be utilized to temper the possibility of a harsh result that could occur from the use of the bright-line test of Rev. Rul. 73-248, *supra*.

Petitioners argue that *Co-Operative Grain & Supply Co. v. Commissioner, supra*, and *Petaluma Co-Operative Creamery v. Commissioner, supra*, support their argument, but the percentages used therein should not be controlling because the taxpayers therein did not argue, nor did this Court determine, that the cooperatives had restricted their stock ownership, as far as possible, to active shareholders. Petitioners argue that those cases are factually distinguishable because petitioners have attempted to restrict the ownership of their stock "as far as possible" to active patrons. With respect to the company, it reduced the period of nonpatronage from 2 years to 1 year (i.e., the period of time after which a shareholder could be asked to redeem his voting stock because he had not patronized the company during that time). This reduction in time could, arguably, have improved the percentage participation in the company. On brief and by stipulation, petitioners presented schedules showing the increase that would occur if we were to consider and delete those nonparticipating shareholders from the computation who were actually purged from voting membership after the year in question. In some instances, considering subsequently purged shareholders, petitioners would have met the 85-percent test. A close scrutiny of petitioners' schedules reflects, however, that, generally, nonparticipating shareholders were not purged for about 12 to 24 months after the close of the measuring year. Additionally, many nonparticipating shareholders were not purged for as long as 36 months after the close of the measuring year.

The company's failure to purge nonparticipating shareholders until generally 1 to 3 years after the close of the measuring year, in essence, more than negates any benefit that could have enured by reducing their nonparticipation period from 2 years to 1. Petitioners request that we favorably consider their delayed action and permit credit for efforts as much as 36 months later to help them meet the 85-percent test. The case law is clear, however, that current patronage on an annualized basis is the standard. *Co-Operative Grain & Supply Co. v. Commissioner, supra.* Based upon the record in this case, we find that the company has failed to restrict stock ownership, as far as possible, to participating shareholders. The society's bylaws and efforts are even less effective than those of the company, and accordingly, we find that the facts and circumstances of these cases do not warrant variance from the 85-percent standard. In so finding, we disagree with petitioners' attempt to distinguish *Co-Operative Grain & Supply Co. v. Commissioner, supra,* and *Petaluma Co-Operative Creamery v. Commissioner, supra.* In those cases, as here, we considered whether the taxpayers restricted stock ownership to eligible patrons by evaluating the effect of a shareholder's death, a shareholder's move from the cooperative's trade territory, and the effect of joint stock ownership between husband and wife.

Petitioners also urge this Court to include persons who became members of the cooperative by patronizing during the course of each year, but did not become shareholders until after the end of the fiscal year. While such "members" were not shareholders, they were entitled to participate in the management and profits for those years. If we were to include such persons in the computation, the company's percentages would increase to 85.45 percent and 83.26 percent, respectively. Petitioners have not provided the figures nor are we able to compute the percentages with respect to the society by including those nonshareholders who transacted business with the society. Petitioners admit that the society's percentages may not be much improved by adding after-admitted members but argue that the society is 5 to 7 times larger than the company and sheer size alone should be sufficient to provide the basis for a different result. We hold that only shareholders who transact business with the cooperative during the year are to be included each year just as shareholders who no longer patronize the cooperative must be removed from the computation. Both inclusion and removal of such "members" are determined after the end of the cooperative's fiscal year when the cooperative determines whether such person had sufficient patronage to earn or to lose a share of stock. The test is whether at least 85 percent of a cooperative's capital *stock* is held by producers. This test presumes that the producers are shareholders during the year. See *Co-Operative Grain & Supply Co. v. Commissioner*, 407 F.2d at 1162. Similar types of arguments have been previously raised before this Court and rejected because "A mere continuing business relationship without actual yearly participation is not a sufficient basis upon which to find current *shareholder* participation of business with the cooperative." *Co-Operative Grain & Supply Co. v. Commissioner, supra*. Emphasis added.

B. 50-Percent-Current-Patronage Test

In addition to requiring that "substantially all" of the shareholders be producers, this Court and the eighth circuit have interpreted section 521(b)(2) to require that the shareholders be current and active patrons. *Co-Operative Grain & Supply Co. v. Commissioner*, T.C. Memo. 1973–164, on remand 407 F.2d 1158, 1160 (8th Cir. 1969). However, neither court quantified this current patronage concept by defining what amount or quantity of business a producer-shareholder must transact in order to qualify as a current and active patron. Petitioners argue that any producer who has transacted *any* or *some* business with the cooperative may be considered an active and current producer of the cooperative during the year. Respondent, on the other hand, argues that a producer can be considered an active or current patron only if he markets or purchases more than 50 percent of his products or supplies through that cooperative during the year relying on Rev. Proc. 73–39, *supra*. We need not decide this quantum of business test because neither petitioner has reached the prerequisite 85-percent test.[11]

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[11] We note that consideration of this area is fraught with many difficulties and problems. Does respondent contemplate that cooperatives will keep track of shareholders' transactions outside the cooperative in order to police the 50-percent test of Rev. Proc. 73–39, 1973–1 C.B. 502? Would cooperatives effectively serve their congressionally intended purpose if patrons were required by contract to transact a minimum amount of business with the cooperative?

C. Patronage-Sourced/Nonpatronage-Sourced

All cooperatives, whether exempt or nonexempt, may deduct amounts paid or allocated to their patrons (patronage dividends). Sec. 1382(b). If a cooperative is exempt, such amounts are deductible regardless of whether they are paid out of patronage-sourced or non-patronage-sourced income. Secs. 1382(c)(2)(A) and 1388(a)(3). If a cooperative is not exempt, however, such amounts are deductible only if paid out of patronage-sourced income. *Pomeroy Cooperative Grain Co. v. Commissioner*, 288 F.2d 326 (8th Cir. 1961), revg. and remanding 31 T.C. 674 (1958); sec. 1388(a)(3). Because we have found that petitioners were not exempt cooperatives during the taxable years at issue and because of concessions made by the parties, we need not address whether the company may deduct the grain storage income they distributed to the patrons.

The parties agree that all but $1,752.89 of the company's 1978 grain storage income was patronage-sourced income. All patronage-sourced income was properly deductible by the company without regard to its tax-exempt status. With respect to the $1,752.89 amount that both parties agreed is nonpatronage-sourced, the company may not deduct this amount because we have found that the company was not exempt for the taxable years at issue.

To reflect the foregoing and concessions made by the parties,

Decisions will be entered under Rule 155.

Reviewed by the Court.

SIMPSON, GOFFE, WILBUR, CHABOT, NIMS, PARKER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, and WRIGHT, *JJ.*, agree with the majority opinion.

KÖRNER and JACOBS, *JJ.*, did not participate in the consideration of this case.

WHITAKER, *J.*, dissenting: I do not believe there is any basis in the statute or the regulations thereunder for the adoption of a "bright-line" test at the level of 85 percent as articulated by respondent in Rev. Rul. 73–248, 1973–1 C.B. 295. The majority opinion effectively adopts this bright-line test and applies it to the facts before us. While arguably the majority felt impelled to reach this result by the rule of *Golsen v. Commissioner*, 54 T.C. 742, 756–758 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971), and the opinion of the eighth circuit in *West Central Cooperative v. United States*, 758 F.2d 1269 (8th Cir. 1985), affg. per curiam an unreported District Court opinion, I do not agree that approval of Rev. Rul. 73–248 is so required. And certainly *Golsen* does not mandate independent adoption of that test by this Court.

Insofar as pertinent, respondent's regulations provide as follows:

> (2) An association which has capital stock will not for such reason be denied exemption (i) * * *, and (ii) if substantially all of such stock (with the exception noted below) is owned by producers who market their products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. [Sec. 1.521–1(a)(2), Income Tax Regs.]

The statute and regulations have been in effect, substantially unchanged, since the Revenue Act of 1926.[1] In fact, insofar as here pertinent, the regulations have been little changed since the version approved on December 20, 1924. See art. 22, Regs. 65, as amended by T.D. 3658, III–2 C.B. 242. The statute has consistently imposed on cooperatives having capital stock the requirement that "substantially all" voting stock must be owned by producers who market through the cooperative.

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[1] The legislative history of this statute is fully described in *Co-Operative Grain & Supply Co. v. Commissioner*, 407 F.2d 1158 (8th Cir. 1969), revg. in part and remanding T.C. Memo. 1967–132.

The term "substantially all" now appears in the Internal Revenue Code over 50 times and is used in regulations over 100 times. In varying contexts, the term has been defined as a fixed percentage ranging from 99 percent (sec. 1.103–15(d)(2), Income Tax Regs.) to a combination of 70 and 90 percent (sec. 1.279–5(d)(2), Income Tax Regs.). Both 85 percent and 80 percent also have been adopted by respondent many times to define "substantially all." If there is any rationale for the varying percentages, it is not readily discernible.

If one concentrated solely on section 521(b)(2), with its emphasis upon voting control, one might logically be led to the congressionally enacted voting control test in section 368(c)(1) which requires "at least 80 percent of the total combined voting power * * * and at least 80 percent of the total number of shares." Rather than focusing on defining "substantially all," however, we should grant great deference to respondent's regulations which are about to acquire "senior citizen" status.[2] The crucial import of those regulations is to be found in the following two sentences:

> Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. [Sec. 1.521–1(a)(2), Income Tax Regs.]

This is a facts-and-circumstances, not a bright-line, test. The examples given—an officer required to have capital stock in order to qualify and a restriction on the ability of the association to recapture stock of a nonproducer—show that respondent, and we must now presume the Congress, intended that each cooperative should essentially be owned and controlled by its producers, and that "substantially all" was not intended to be reflected as a percentage. The regulations allow that amount of nonproducer ownership, and only that amount, reasonably required by the particular circumstances. Thus, the issue which should have been addressed by the majority is whether the cooperatives reasonably justified the extent of stock ownership by nonactive producers.

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[2] As stated in *Helvering v. Winmill,* 305 U.S. 79, 83 (1938):

"Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received Congressional approval and have the effect of law."

This Court has in earlier cases recognized the propriety of failing to establish a bright line. We have simply defined outer limits. See *Farmers Co-Operative Creamery v. Commissioner*, 21 B.T.A. 265, 269 (1930), where we held that 91 percent satisfies the requirements of section 521, and *Co-Operative Grain & Supply Co. v. Commissioner*, T.C. Memo. 1973–164, on remand 407 F.2d 1158 (8th Cir. 1969), revg. in part and remanding T.C. Memo. 1967–132, where we held that neither 78 percent nor 72 percent satisfies the requirement. Between those outer limits, at least until respondent promulgated Rev. Rul. 73–248, *supra*, the test was entirely one of facts and circumstances, as demanded by respondent's regulations. While the majority suggests that the 85-percent test is not entirely rigid, the regulations are in fact largely abrogated, first by respondent and now by the majority.

The majority commits another error of policy by according to a revenue ruling substantially the stature normally accorded to a regulation. "[A] 'Revenue Ruling' is an official interpretation by the Service, issued only by the National Office and published in the Internal Revenue Bulletin for the information and guidance of taxpayers, Service personnel, and others concerned." Rogovin, "The Four R's: Regulations, Rulings, Reliance, and Retroactivity—A View From Within," 43 Taxes 756, 764 (1965). As Mr. Rogovin points out, revenue rulings and letter rulings are merely part of respondent's rulings program. While certainly useful, these statements of respondent's position "are not entitled to any particular weight." *Anselmo v. Commissioner*, 80 T.C. 872, 883 n. 13 (1983), affd. 757 F.2d 1208 (11th Cir. 1985). The Fifth Circuit has well said: "A ruling is merely the opinion of a lawyer in the agency and must be accepted as such. It may be helpful in interpreting a statute, but it is not binding on the Secretary or the courts. It does not have the effect of a regulation or a Treasury Decision." *Stubbs, Overbeck & Associates, Inc. v. United States*, 445 F.2d 1142, 1146–1147 (5th Cir. 1971).

The majority speculates (see note 10) that Rev. Rul. 73–248 was issued in response to the evident displeasure of the eighth circuit in *Co-Operative Grain & Supply Co. v. Commissioner*, *supra*, at the lack of specific guidance in the form of "regulations or rulings." If respondent wished to establish a bright-line test, at 85 or any other percentage, the only appropriate way to do so would be by the promulgation of an amending regulation which would have allowed interested cooperatives to comment at a public hearing. The fixing of a safe harbor or perhaps establishment of outer limits (if wide enough) by revenue ruling may be appropriate since more easily accomplished than by regulation promulgation. In any event, such a bright-line test is justified largely for administrative convenience. Its establishment is an appropriate function for the Congress or the Treasury Department by regulation but not for this or any other Court. The majority simply encourages avoidance of the regulation process.

STERRETT, J., agrees with this dissent.

RONALD COLEMAN AND NANCY COLEMAN, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 7216-83.

By order dated January 28, 1986, opinion filed October 24, 1985, was withdrawn, and decision entered October 31, 1985, was vacated and set aside.

Pages 623–656 have been
deleted from this volume.

Ramon and Audra V. Fuentes, Petitioners v. Commissioner of Internal Revenue, Respondent

Docket No. 4980–84. Filed October 29, 1985.

On Oct. 31, and Nov. 1, 1979, petitioners acquired and placed in service four railroad boxcars. Petitioners claimed a depreciation deduction in 1979 for the boxcars using a half-year or averaging convention. *Held*: Petitioners are not entitled under sec. 167(a) and (m), I.R.C. 1954, to use, in computing their depreciation deduction for the boxcars, either a half-year convention under the Class Life Asset Depreciation Range System (CLADR), sec. 1.167(a)-11, Income Tax Regs., or an averaging convention applied to a multiple asset account, sec. 1.167(a)-10(b), Income Tax Regs. Petitioners' depreciation deduction for the boxcars is limited to an amount computed with respect to the 2 months in 1979 during which the boxcars were used by petitioners.

Ramon Fuentes, pro se.
James D. Hill, for the respondent.

OPINION

FEATHERSTON, *Judge*: Respondent determined a deficiency in the amount of $1,881.67 in petitioners' Federal income tax for 1979. The only issue for decision is whether petitioners are entitled under section 167(a) and (m)[1] and related regulations to use a half-year or averaging convention in determining their depreciation deduction with respect to four railroad boxcars acquired by petitioners and placed in service during 1979.

All the facts are stipulated.

Petitioners Ramon and Audra V. Fuentes resided in Williamstown, West Virginia, at the time the petition was filed. They filed a joint Federal income tax return for 1979 with the Internal Revenue Service Center, Memphis, Tennessee.

On October 31 and November 1, 1979, petitioners acquired four general purpose railroad boxcars with a collective cost basis of $173,364.68. Two of the boxcars were placed in service on October 31, 1979, and two were placed in service on November 1 of that year. Petitioners computed their depreciation deduction using the double declining balance method and a 12-year useful life and claimed a deduction for the four boxcars collectively on their 1979 tax returns as follows:

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[1] All section references are to the Internal Revenue Code of 1954 as amended, unless otherwise noted.

DEPRECIATION SCHEDULE

	Date acquired	*Cost*	*Depreciation prior yrs.*	*Method*	*Life*	*Depreciation 1979*
Four boxcars	11/79	$173,364.68	0	DDB	12 yrs.	1/2 yr. $14,113.72
First-year bonus depreciation[2]						4,000.00
Total depreciation						18,113.72

Petitioners received assistance in preparing their 1979 income tax return from James B. Dunn, a certified public accountant. Had Mr. Dunn been available to testify at trial, he would have stated that, in computing petitioners' depreciation deduction with respect to the four boxcars, he employed a method of depreciation consistently used by his accounting firm on petitioners' prior returns with respect to other depreciable assets, and on returns of the firm's other clients.

In the notice of deficiency, respondent redetermined petitioners' depreciation deduction for the boxcars as $4,704.58 (2 months' depreciation), stating that "your deduction is limited to the time the asset was placed in service during the taxable year."

Petitioners have not filed a brief but they have alleged in their petition that they are entitled to 6 months' (or a half-year's) depreciation as an "accounting convention," because (1) petitioners have "always deducted one-half years depreciation expense in the year the asset is acquired and * * * in the year the asset is disposed of"; (2) the "accounting convention used is an accepted method of determining depreciation expense"; and (3) the "method does not materially understate or overstate income for that year."

Section 167(a) provides for a reasonable allowance (depreciation) for the exhaustion, wear and tear of property used in a trade or business or held for the production of income. Section 1.167(a)-10(b), Income Tax Regs., provides that the period for depreciation of an asset generally begins when the asset is placed in service. The regulation further provides that, for the year the asset is placed in service, a proportionate part of one year's depreciation is allowable, as a general rule, for that part of the first year during which the asset was in service. An exception to this general rule is the use of a half-year or averaging convention to compute the depreciation deduction for the first year an asset is placed in service. Use of a half-year or averaging convention is permitted only where: (1) An election is made pursuant to the regulations under section 167(m)(1)[3] to depreciate the asset under the Class Life Asset Depreciation Range System (CLADR) (sec. 1.167(a)–11, Income Tax Regs.) (half-year convention); or (2) assets in a multiple asset account are depreciated under an averaging convention (sec. 1.167(a)–10(b), Income Tax Regs.) (averaging convention).

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[2] Respondent does not dispute petitioners' allowance for first-year depreciation under sec. 179 in the amount of $4,000.

1. Election of CLADR

Section 167(m)(1) provides that, in the case of a taxpayer who has so elected, the term "reasonable allowance" means, with respect to property for which a class life has been prescribed, an allowance based on the class life which reasonably reflects the anticipated useful life of that class of property to the industry or other group. The regulations under this section permit the use of a half-year or modified half-year convention[4] in computing a depreciation deduction for the first year the asset is placed in service, provided that the taxpayer properly elects to depreciate that asset under CLADR. Sec. 1.167(a)–11(c)(2), Income Tax Regs. Paragraph (f) of the foregoing regulation specifies the time and manner of the CLADR election and requires that the taxpayer furnish certain information with the election.[5] Paragraph (4) of section 1.167(a)–11(f), Income Tax Regs., further describes specific information that must be maintained in a taxpayer's books and records.

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[3] Sec. 167(m)(1) provides as follows:

SEC. 167(m). CLASS LIVES.—

(1) IN GENERAL.—In the case of a taxpayer who has made an election under this subsection for the taxable year, the term "reasonable allowance" as used in subsection (a) means (with respect to property which is placed in service during the taxable year and which is included in any class for which a class life has been prescribed) only an allowance based on the class life prescribed by the Secretary which reasonably reflects the anticipated useful life of that class of property to the industry or other group. The allowance so prescribed may (under regulations prescribed by the Secretary) permit a variance from any class life by not more than 20 percent (rounded to the nearest half year) of such life.

Sec. 167(m) does not apply to recovery property, within the meaning of sec. 168, placed in service after Dec. 31, 1980. Sec. 167(m)(4).

[4] The half-year convention treats all assets as placed in service on the first day of the second half of the taxable year. Sec. 1.167(a)–11(c)(2)(iii), Income Tax Regs. The modified half-year convention treats all assets placed in service during the first half of the taxable year as placed in service on the first day of that year, and treats all assets placed in service during the second half of the taxable year as placed in service on the first day of the following taxable year. Sec. 1.167(a)–11(c)(2)(ii), Income Tax Regs.

Nothing in petitioners' 1979 tax return indicates an intention to elect CLADR. Petitioners did not attach to their return a Form 4832 referred to in the flush language of section 1.167(a)–11(f)(2), Income Tax Regs., nor did they provide elsewhere on their return the information specified in section 1.167(a)–11(f)(2), Income Tax Regs. The fraction "½" which appears on their depreciation schedule may indicate petitioners' intent to employ a half-year convention for computing the depreciation deduction, but it in no way complies with the regulation for electing CLADR. Further, petitioners have not shown that they maintained the books and records prescribed by section 1.167(a)–11(f)(4), Income Tax Regs.

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[5] Sec. 1.167(a)–11(f), Income Tax Regs., provides:

(f) *Election with respect to eligible property*—(1) *Time and manner of election*—(i) *In general.* An election to apply this section to eligible property shall be made with the income tax return filed for the taxable year in which the property is first placed in service * * * by the taxpayer. * * *

(2) *Information required.* A taxpayer who elects to apply this section must specify in the election:

(i) That the taxpayer makes such election and consents to, and agrees to apply, all the provisions of this section;

(ii) The asset guideline class for each vintage account of the taxable year;

(iii) The first-year convention adopted by the taxpayer for the taxable year of election;

(iv) Whether the special 10 percent used property rule described in paragraph (b)(5)(iii) of this section has been applied to exclude used property from the election;

(v) Whether the taxpayer elects to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section;

(vi) Whether the taxpayer elects for the taxable year to allocate the adjusted basis of a special basis vintage account in accordance with paragraph (d)(3)(vi) of this section;

(vii) Whether any eligible property for which the taxpayer was not required or permitted to make an election was excluded because of the special rules of paragraph (b)(5)(v) or (6), or paragraph (e)(3)(i) or (iv) of this section;

(viii) Whether any "section 38 property" was excluded under paragraph (b)(5)(iv) of this section from the election to apply this section;

* * * * * * *

(x) Such other information as may reasonably be required.

The information required under this subparagraph may be provided in accordance with rules prescribed by the Commissioner for reasonable grouping of assets or accounts. Form 4832 is provided for making an election and for submission of the information required. An election may be made and the information submitted only in accordance with Form 4832. An election to apply this section will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith, with the requirements of this subparagraph.

Furnishing the information required by section 1.167(a)–11(f)(2), Income Tax Regs., and maintaining the books and records prescribed by section 1.167(a)–11(f)(4), Income Tax Regs., are not merely technical considerations. When transactions extend over a number of years (as do depreciation accounts) and tax benefits have been obtained in the earlier years, it is necessary for the Internal Revenue Service to be able to trace the tax history of the transactions. Otherwise, the Internal Revenue Service would not have the information needed to assure reasonable compliance with the revenue laws.

We find that petitioners did not make a valid election to depreciate the boxcars under CLADR as prescribed by the regulations; and therefore, they are precluded from using a half-year convention to compute the depreciation deduction.[6]

2. Election of "Multiple Asset Account" Convention

In the case of a taxpayer who has not elected to depreciate his assets under CLADR, but who maintains a "multiple asset account," the amount of depreciation may be determined by using an assumed timing of additions to and retirements from the account, or averaging convention. Sec. 1.167(a)–10(b), Income Tax Regs. One such averaging convention assumes that additions to and retirements from the account occur uniformly throughout the year, and depreciation is computed on the average of the beginning and ending balances of the asset account for that year. Application of this particular averaging convention results in a depreciation deduction of one-half that allowed for an entire year, or 6 months' depreciation allowance, the same result as under the CLADR half-year convention. However, section 1.167(a)–10(b), Income Tax Regs., further requires:

> An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

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[6] See *Caulkins v. Commissioner*, T.C. Memo. 1984–504; *Regan v. Commissioner*, T.C. Memo. 1982–733.

Respondent argues initially that petitioners' depreciation account, consisting of four railroad boxcars purchased in 1979, does not constitute a multiple asset account within the meaning of the regulations. A multiple asset account consists of two or more depreciable assets grouped together in a variety of ways. One such multiple asset account, a "group account," combines assets which are similar in kind and have approximately the same useful lives. Sec. 1.167(a)-7(a), Income Tax Regs. Although petitioners did not label their account as such, we think petitioners' grouping of four railroad boxcars acquired and placed in service in the same year qualifies as a multiple asset account of the "group account" type.

Respondent further contends that use of an averaging convention in the instant case results in a material distortion of depreciation. Section 1.167(a)-10(b), Income Tax Regs., specifically proscribes the use of an averaging convention when large and unusual acquisitions would have the effect of substantially distorting the depreciation allowance for the year.[7] The objective of the regulation on multiple asset accounts is to simplify depreciation accounting where multiple assets are acquired or disposed of during the taxable year. The simplification results not solely from the combination of multiple assets in one account (see sec. 1.167(a)-7(a), Income Tax Regs.), but from the consistent treatment of multiple transactions under one chosen averaging assumption. The purpose underlying the regulation is best served where, unlike the present case, additions and retirements affecting a multiple asset account are made at various times over a taxable year.[8]

While petitioners urge that their use of a depreciation convention does not materially understate or overstate their 1979 income, the foregoing regulation refers not to a distortion of income, but to a substantial distortion of the annual depreciation allowance. Thus, the appropriate measure of depreciation distortion requires a comparison of the depreciation claimed for the asset account computed in accordance with the averaging convention, and the depreciation deduction otherwise allowable without reference to such convention.[9]

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[7] *Caulkins v. Commissioner, supra.*

[8] *Helfand v. Commissioner,* T.C. Memo. 1984-102.

Petitioners computed their depreciation deduction for the four boxcars under the double declining balance method using a half-year or averaging convention resulting in 6 months' depreciation allowance for 1979 in the amount of $14,113.72. Petitioners, having placed the assets in service on October 31 and November 1 of that year, would be entitled to 2 months' depreciation for 1979, or $4,704.58, if no convention were employed. A comparison of these figures demonstrates that the depreciation convention used by petitioners resulted in substantial distortion of their depreciation allowance for the four railroad boxcars for 1979.

To reflect the foregoing,

Decision will be entered for the respondent.

HUGHES A. BAGLEY AND MARILYN B. BAGLEY, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 18838–82. Filed October 30, 1985.

In 1975, petitioner Hughes A. Bagley was granted an option to purchase 10,000 shares of his employer's common stock. In 1978, petitioner received from his employer a $70,000 payment in exchange for the termination of the option, and a $50,000 fee in exchange for his agreement to perform consulting services for 1 year. The consulting fee was reported as income on the Federal income tax returns of a corporation wholly owned by petitioner. *Held*, the $70,000 received by petitioner in exchange for the termination of the option is treated as compensation under sec. 83, I.R.C. 1954, and is thus taxable as ordinary income. *Held, further*, the $50,000 consulting fee received by petitioner is taxable to him and not to his wholly owned corporation.

Sam S. Killinger, for the petitioners.

J. Anthony Hoefer, for the respondent.

FAY, *Judge*: Respondent determined a deficiency of $40,760 in petitioners' 1978 Federal income tax. The issues are (1) whether a payment received by petitioner Hughes A. Bagley from his employer in exchange for the termination of an employee stock option is taxable as capital gain or as ordinary income; and (2) whether a consulting fee received by petitioner Hughes A. Bagley is taxable to him or rather, to his wholly owned corporation.

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[9] *Helfand v. Commissioner, supra.*

FINDINGS OF FACT

Some of the facts have been stipulated and are so found.

Petitioners Hughes A. Bagley and Marilyn B. Bagley are husband and wife. They timely filed a joint Federal income tax return for 1978 with the Internal Revenue Service Center at Kansas City, Missouri. Petitioners resided in Sioux City, Iowa, when they filed their petition herein.[1]

In August 1975, petitioner Hughes A. Bagley (herein petitioner), commenced working as a consultant for Spencer Foods, Inc., a Delaware corporation having a place of business in Spencer, Iowa (herein Spencer Foods). Spencer Foods was engaged in meat packing and processing, a business in which petitioner had extensive prior experience.

On November 5, 1975, petitioner and Spencer Foods entered into an employment agreement (herein the employment agreement), pursuant to which Spencer Foods agreed to employ petitioner for 5 years as vice president of its Breaking and Fabricating Division. The employment agreement provided that petitioner would receive annually a fixed salary of $50,000 and a discretionary bonus, and would be granted a qualified stock option to purchase 10,000 shares of common stock of Spencer Foods.[2]

The employment agreement contained several provisions concerning the option which petitioner would be granted. It provided that, in the event Spencer Foods were acquired by another entity, petitioner would have the right to receive, in exchange for his option, an amount equal to the difference between (a) the exercise price of the option granted to him and (b) the closing market price of Spencer Foods' stock on the closing date of such acquisition. It further provided that the option would remain in force throughout the 5-year term of the employment agreement, even if petitioner's employment with Spencer Foods were terminated earlier for any reason other than dishonesty or neglect of duty on the part of petitioner.[3]

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[1] Petitioner Marilyn B. Bagley is a party to this proceeding only by virtue of the joint return filed by petitioners for the taxable year here in issue.

[2] Par. 4 of the employment agreement, in which petitioner and Spencer Foods were referred to respectively as "Employee" and "Employer," provided as follows:

"4. In addition to the salary and bonus provisions above provided for, the Employee shall be granted a qualified stock option to purchase 10,000 shares of Employer's common stock under the provisions and in accordance with the terms of its Qualified Stock Option Plan, at an exercise price equal to the closing price of such stock on the American Stock Exchange on the date of this Agreement."

Consistent with the terms of the employment agreement, petitioner and Spencer Foods executed a document dated November 21, 1975, and captioned "Spencer Foods, Inc.—Option Agreement—1969 Qualified Stock Option Plan" (herein the option agreement), which granted to petitioner an option to purchase 10,000 shares of common stock of Spencer Foods at an exercise price of $5 per share (herein the option). It referred to petitioner as a "key employee," and provided that the option was subject to the terms and conditions of the option agreement and of Spencer Foods' 1969 Qualified Stock Option Plan (herein the stock option plan).[4] The stock option plan indicated that its purposes, among others, were to assist Spencer Foods in retaining the services of its executives and key employees and to offer such personnel additional incentives to put forth maximum efforts for the success of the business.

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[3] Par. 5 of the employment agreement provided in relevant part as follows:

"5. It is further understood and agreed that in the event Employer shall merge with or become a subsidiary of or sell substantially all of its assets to any other person, firm or corporation * * *, the Employee shall have the right, upon ten days prior written notice to the Employer, to receive (on or prior to the date of closing of any such merger or sale transaction) an amount in cash equal to the difference between the stock option exercise price and the closing market price of Employer's common stock on such closing date. It is further agreed that in event Employee's employment with Employer is terminated for any reason (except for * * * [dishonesty or neglect of duty on the part of petitioner]) prior to the five-year term of this Employment Agreement, said stock option shall remain in force and effect for the remainder of such five-year period (but without representation by the Employer that it will continue to be deemed a "qualified" option under the provisions of the Internal Revenue Code * * *)."

Petitioner insisted on inclusion of the provisions of par. 5 in the employment agreement for his protection in the event Spencer Foods sought to terminate his employment or if another company sought to acquire Spencer Foods. Prior to his employment with Spencer Foods, petitioner had been employed by Iowa Beef Processors (IBP), which had granted him stock options. When IBP prematurely terminated his employment, petitioner was unable to exercise or otherwise benefit from the IBP options. Petitioner sought to avoid a similar situation with respect to the option granted to him by Spencer Foods.

[4] Par. 1 of the option agreement, in which petitioner and Spencer Foods were referred to respectively as "Optionee" and "Spencer," provided, in part, as follows:

"Spencer hereby grants to Optionee the right and option to purchase 10,000 shares of the Common Stock $1.00 par value per share, of Spencer at a price of $5.00 per share on the terms and conditions set forth in this grant, and in the 1969 Qualified Stock Option Plan. * * *

"The Optionee agrees to remain in the employ of Spencer * * * for a period of not less than two (2) years * * *. In the event the Optionee shall have an employment contract with Spencer * * * and such employment contract might be deemed to be inconsistent with the provisions of this paragraph, then the provisions of said employment contract shall control."

The option was not immediately exercisable in full by petitioner; the option agreement provided that for each 12-month period during which the option was outstanding, petitioner would be entitled to purchase 20 percent of the shares subject thereto. If less than the allowable 20 percent of the shares were purchased in any 12-month period, the portion not purchased could be subsequently acquired. Moreover, under the terms of both the option agreement and the stock option plan, the option was not transferable by petitioner other than by will or the law of descent and distribution and could be exercised during petitioner's lifetime only by him.

During the early part of 1978, petitioner spent several months in Florida reviewing the operations of a subsidiary of Spencer Foods. Spencer Foods ultimately decided that the subsidiary should be sold, and petitioner undertook to find a buyer. Petitioner negotiated on behalf of Spencer Foods with Trade Winds Inc., a corporation which was willing to purchase the subsidiary on the condition that petitioner manage the operations of the subsidiary on its behalf. Although Spencer Foods was amenable to such an arrangement, the transaction ultimately was not consummated.

During his stay in Florida, petitioner formed a corporation under the laws of that State, Hereford Trading Corp. (herein Hereford Trading), of which he was president and sole shareholder.[5]

In July or August, 1978, petitioner returned from Florida to Iowa. At that time, Land O'Lakes, Inc., a Minnesota corporation (herein Land O'Lakes), made a tender offer to purchase all of the issued and outstanding shares of common stock of Spencer Foods at $12 per share. In view of the impending acquisition by Land O'Lakes, petitioner and Spencer Foods sought to amicably terminate their employment relationship and their respective obligations under the employment agreement. Accordingly, they entered into an agreement and release dated September 1, 1978, under which petitioner resigned as an officer and employee, and expressly released Spencer Foods from any further liabilities under the employment agreement. Pursuant to the agreement and release, petitioner agreed to make himself available for a 1-year period to perform consulting services and to assist in the transition to new management following the acquisition by Land O'Lakes. For its part, Spencer Foods agreed to pay petitioner a consulting fee of $50,000. Such payment was made on September 8, 1978, by means of a check payable to the order of petitioner. Neither the agreement and release, pursuant to which petitioner agreed to provide consulting services, nor the check by which Spencer Foods paid the consulting fee, made any reference to Hereford Trading.

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[5] The record is unclear concerning petitioner's purpose in forming Hereford Trading. The only evidence on this point was the following testimony given by petitioner on direct examination:

Q. What was the purpose for which you set up Hereford Trading Corporation?

A. Well, I would have had two incomes at that time, and I was setting up a separate corporation in Flordia. A & P at that time, were disposing of numerous supermarkets up and down the Florida coast. I had hoped to be able to buy one of those, financed by a company out of Geneva, Alabama, and put my sons in the supermarket business.

At the time of Land O'Lakes tender offer, petitioner had not yet exercised any part of the option. Accordingly, consistent with the terms of the employment agreement,[6] the agreement and release further provided that, upon the consummation of the Land O'Lakes tender offer, the option would terminate and, in exchange therefor, Spencer Foods would pay petitioner $7 for each of the 10,000 shares of stock subject to the option. This amount represented the difference between the $5-per-share exercise price of the Option and the $12-per-share price offered by Land O'Lakes.[7] Thereafter, the acquisition of Spencer Foods by Land O'Lakes was consummated. Accordingly, the option was terminated, and Spencer Foods paid to petitioner the sum of $70,000 in consideration therefor.

On their joint Federal income tax return for 1978, petitioners reported the $70,000 received in exchange for the termination of the option as a long-term capital gain. They did not report as income the $50,000 consulting fee paid to petitioner by Spencer Foods. However, the consulting fee was reported on the Federal income tax returns of Hereford Trading for its taxable years ended January 31, 1979, and January 31, 1980.[8]

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[6] See note 3 and accompanying text *supra*.

[7] On Sept. 22, 1978, petitioner and Spencer Foods also executed an "Agreement to Terminate Stock Option," in which they reiterated their agreement concerning the termination of the option.

In his notice of deficiency, respondent determined that the $70,000 received by petitioner in exchange for the termination of the option was taxable as ordinary income, and that the $50,000 consulting fee was taxable to petitioner rather than to Hereford Trading.

OPINION

Issue 1. Termination of Stock Option

The first issue is whether the $70,000 received by petitioner in exchange for the termination of the option is taxable as ordinary income, or instead, as capital gain.

Respondent asserts that resolution of this issue is governed by section 83,[9] which relates generally to the transfer of property in connection with the performance of services. He argues that, under the rules of that section, petitioner must treat the $70,000 received in exchange for the termination of the option as compensation. Petitioner's primary argument, as we understand it, is that the option was not transferred in connection with the performance of services, and thus is not governed by section 83. He asserts, therefore, that the option was not compensatory and that the amount received upon termination thereof was taxable as capital gain. For the following reasons, we agree with respondent.[10]

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[8] Of the $50,000 fee, $20,833 was reported by Hereford Trading on its Federal income tax return for the taxable year ending Jan. 31, 1979, and $29,167 was reported on its Federal income tax return for the taxable year ending Jan. 31, 1980. Hereford Trading is not a party to this proceeding, and we are not called upon in this case to decide the propriety of its reporting of the $50,000 fee over 2 taxable years.

[9] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[10] Sec. 83 and the regulations thereunder govern the tax treatment of certain options, formerly governed by sec. 1.421–6, Income Tax Regs., which were granted after June 30, 1969. See sec. 1.421–6(a)(2), Income Tax Regs.; see also *Robinson v. Commissioner*, 82 T.C. 444, 452–453 (1984); *Pledger v. Commissioner*, 71 T.C. 618, 629 (1979), affd. 641 F.2d 287 (5th Cir. 1981), cert. denied 454 U.S. 964 (1981). Prior to the enactment of sec. 83, this Court previously addressed the issue herein presented in *Kunsman v. Commissioner*, 49 T.C. 62 (1967). There, the taxpayer received a payment from his employer in exchange for the termination of stock options issued under the employer's restricted stock option plan. Relying upon sec. 1.421–6, Income Tax Regs., this Court determined that the amount so received was treated as compensation and thus was taxable as ordinary income, rather than capital gain. We further held that sec. 1234, relating to the tax treatment of certain options to buy or sell property, did not require a contrary holding. Other courts faced with the issue have reached a similar conclusion, also based upon sec. 1.421–6, Income Tax Regs. See *Rank v. United States*, 345 F.2d 337 (5th Cir. 1965); *Dugan v. United States*, 234 F. Supp. 7

A. Applicability of Section 83

Section 83 provides in general that, where property is transferred in connection with the performance of past, present, or future services, the excess of the fair market value of the property over the amount, if any, paid for the property, is includable as compensation in the gross income of the taxpayer who performed the services.[11] See secs. 83(a), 83(i); secs. 1.83–1(a)(1), 1.83–3(e), Income Tax Regs. See also *Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984), affg. 79 T.C. 864 (1982); *Sakol v. Commissioner*, 574 F.2d 694 (2d Cir. 1978), affg. 67 T.C. 986 (1977); *Cohn v. Commissioner*, 73 T.C. 443 (1979). However, section 83 is inapplicable to a transaction to which section 421, relating to certain qualified and other options, applies. See sec. 83(e)(1); sec. 1.83–7, Income Tax Regs. Thus, in order for section 83 to be applicable with respect to a stock option, two conditions must be satisfied. First, the option must be transferred in connection with the performance of services. Second, the transaction involving the option must be one to which section 421 does not apply. See sec. 83(a), sec. 83(e)(1); sec. 1.83–7, Income Tax Regs. We conclude that both requirements are satisfied in this case.

Whether property is transferred in connection with the performance of services is essentially a question of fact. See sec. 1.83–3(f), Income Tax Regs. Cf. *Alves v. Commissioner*, 734 F.2d 478, 481 (9th Cir. 1984). Although petitioner argues otherwise, a review of the facts herein clearly establishes that the option was granted by Spencer Foods in connection with petitioner's performance of services.

The grant of the option was provided for in the employment agreement, pursuant to which petitioner agreed to render services as an employee of Spencer Foods. For its part, Spencer Foods agreed to pay petitioner a salary and bonus, and to grant him an option to purchase shares. The option was granted under the option agreement, which referred to peti-

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(S.D.N.Y. 1964).

Sec. 1.421–6, Income Tax Regs., relied upon in the above-cited cases, generally does not apply to options granted after June 30, 1969. See sec. 1.421–6(a)(2), Income Tax Regs. Its provisions are thus inapplicable herein, since the option was granted to petitioner in November 1975.

[11] Sec. 83 is generally applicable with respect to property transferred after June 30, 1969. Sec. 83(i) sets forth transitional rules which provide several exceptions concerning the June 30, 1969, date, none of which is relevant herein.

tioner as a "key employee," and was governed by the provisions of the stock option plan. The purposes of granting options under the stock option plan, were, among others, to assist Spencer Foods in retaining the services of its executives and key employees and to offer such personnel additional incentives to put forth maximum efforts for the success of the business. Moreover, the sole consideration furnished by petitioner to Spencer Foods in exchange for the option was his promise to render services as an employee. In view of the employment relationship between Spencer Foods and petitioner, as well as the tenor of the documents relating to the option, it is apparent that Spencer Foods' intent in granting the option was to compensate and better secure petitioner's services as its employee. Cf. *Commissioner v. LoBue*, 351 U.S. 243, 247 (1956). Accordingly, we conclude for purposes of section 83 that the option was transferred to petitioner in connection with the performance of services.[12]

In order for section 83 to be applicable herein, the transaction involving the option must be one to which section 421 does not apply. See sec. 83(e)(1); sec. 1.83-7, Income Tax Regs. Section 421(a), in conjunction with section 422(a), provides generally that no income shall result at the time of the transfer of a share of stock upon the exercise of a qualified stock option if no disposition of such share is made within a prescribed 3-year period.[13] Although the option purported to

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[12] Our conclusion is not altered by the fact that under par. 5 of the option agreement, petitioner could have exercised the option during the prescribed 5-year period even if his employment with Spencer Foods were terminated earlier. This provision was inserted at petitioner's insistence primarily to discourage Spencer Foods from terminating his employment prior to the expiration of the 5-year period set forth in the employment agreement. See note 2 *supra*. Thus, we draw no inference therefrom that the option was not transferred to petitioner in connection with the performance of services.

[13] As relevant herein, sec. 421(a) provides as follows:

> SEC. 421(a). EFFECT OF QUALIFYING TRANSFER.—If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a), * * * are met—
>
> (1) * * *, no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;

In turn, sec. 422(a) provides as follows:

> SEC. 422(a). IN GENERAL.—Subject to the provisions of subsection (c)(1), section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of a qualified stock option if—
>
> (1) no disposition of such share is made by such individual within the 3-year period beginning on the day after the day of the transfer of such share, and
>
> (2) at all times during the period beginning with the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of

be a qualified stock option.[14] section 421 is inapplicable herein. In order for that section to be applicable, "the option must be exercised, the stock held for the requisite period and then sold according to the provisions of the statute. Where the option itself is transferred or cancelled prior to exercise, section 421 is not applicable. *Mitchell v. Commissioner*, 65 T.C. 1099, 1110 (1976), affd. 590 F.2d 312 (9th Cir. 1979). Thus, since the option was terminated prior to exercise, section 421 is inapplicable.

Accordingly, since the option was transferred to petitioner in connection with the performance of services, and since section 421 is not applicable, we conclude that the tax consequences of the option are governed by section 83.[15]

B. Effect of Section 83

A person who receives an option to which section 83 is applicable will be taxed either (a) at grant or (b) at exercise or disposition thereof, depending upon whether the option has a readily ascertainable fair market value when granted. See secs. 83(e)(3), 83(e)(4). Sec. 1.83–7, Income Tax Regs. If the option has a readily ascertainable fair market value when granted, section 83 causes the realization of compensation income at the time of the grant of the option. See secs. 83(a), 83(e)(3); sec. 1.83-7(a), Income Tax Regs. If such an option does not have a readily ascertainable fair market value when granted, section 83 causes the realization of compensation income at the time the option is exercised or disposed of. See secs. 83(a), 83(e)(4); sec. 1.83–7(a), Income Tax Regs. Cf. *Robinson v. Commissioner*, 82 T.C. 444 (1984). For the following reasons, we hold that the option did not have a readily ascertainable fair market value when granted, and according-

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either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 425(a) applied.

[14] See sec. 422(b). We have, without deciding, assumed that the option was a qualified stock option. We note that the employment agreement contained several provisions relating to the option. See note 3 and accompanying text *supra*. We need not consider whether such provisions would cause the option to not satisfy the requirements set forth in sec. 422(b) pertaining to qualified stock options, since sec. 83 would also be applicable in the same manner as herein described, and would mandate the identical result reached herein if the option were not a qualified stock option. See sec. 83(a); sec. 1.83–7, Income Tax Regs. Cf. *Robinson v. Commissioner, supra; Pledger v. Commissioner, supra.*

[15] Cf. *Horwith v. Commissioner*, 71 T.C. 932 (1979), in which the rules of sec. 83 were applicable when stock was received upon the surrender of unexercised qualified stock options.

ly, that the rules of section 83 are applicable upon the termination of the option.

For purposes of section 83, an option generally does not have a readily ascertainable fair market value when granted unless it is actively traded on an established market. Sec. 1.83–7(b)(1), Income Tax Regs. Petitioner concedes that the option was not actively traded on an established market. Under section 1.83–7(b)(2), Income Tax Regs., an option not actively traded on an established market is considered not to have a readily ascertainable fair market value when granted unless the taxpayer can show that, at such time, all of the following conditions exist:

> (i) The option is transferable by the optionee;
>
> (ii) The option is exercisable immediately in full by the optionee;
>
> (iii) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option; and
>
> (iv) The fair market value of the option privilege is readily ascertainable in accordance with paragraph (b)(3) of [sec. 1.83–7, Income Tax Regs.].

Cf. *Welsh v. United States*, 2 Cl. Ct. 417 (1983); *Mitchell v. Commissioner, supra; Shamburger v. Commissioner*, 61 T.C. 85 (1973), affd. per curiam 508 F.2d 883 (8th Cir. 1975).

It is clear that the option fails to satisfy several of these conditions. When granted, the option did not satisfy the first prescribed condition of section 1.83–7(b)(2), Income Tax Regs., since, under the terms of the option agreement and the stock option plan, it was not transferable by petitioner other than by will or the laws of descent and distribution. Moreover, the option did not satisfy the second condition set forth in section 1.83–7(b)(2)(ii), Income Tax Regs., since, under the terms of the option agreement, it was not immediately exercisable in full by petitioner; it could only be exercised as to 20 percent of the shares subject thereto for each 12-month period following the grant of the option.[16] Since petitioner is required to show that the option satisfied all of the conditions set forth in sec. 1.83–7(b)(2), Income Tax Regs., and we have held that it failed to satisfy two of such conditions, we need not consider whether the option satisfied the remaining conditions set forth therein. Cf. *Mitchell v. Commissioner, supra*; *Shamburger v. Commissioner*, 61 T.C. 85 (1973). Thus, since the option was not actively traded on an established market, and not all of the conditions of section 1.83–7(b)(2), Income Tax Regs., were satisfied, the option's fair market value at grant was not readily ascertainable within the meaning of section 1.83–7(b), Income Tax Regs.

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[16] Focusing on the last sentence of par. 1 of the option agreement, petitioners argue that the option was, in effect, governed only by the employment agreement and not subject to the restrictions contained in the option agreement and in the stock option plan. See note 4 *supra*. We reject petitioners' argument. We construe par. 1 of the option agreement to mean that the option was generally subject to the terms and conditions set forth in the option agreement and the stock option plan. We interpret the last sentence thereof to mean only that, insofar as the provisions of the employment agreement concerning the 5-year term of petitioner's employment differed from

Section 1.83–7(a), Income Tax Regs., provides that if an option not having a readily ascertainable fair market value when granted is sold or otherwise disposed of in an arm's-length transaction, the person who performed the services realizes compensation income at such time under the rules of section 83. Since the amount received by petitioner was based upon the difference between the previously fixed exercise price of the option and the tender offer price offered by Land O'Lakes to all shareholders of Spencer Foods, we conclude that the termination of the option constituted a disposition in an arm's-length transaction for purposes of section 1.83–7, Income Tax Regs.,[17] and that petitioner realized compensation income at the time of such termination. Sec. 1.83–7(a), Income Tax Regs.

Under the general rule of section 83(a), compensation income is measured by the excess of the fair market value of the "property" transferred over the amount, if any, paid for the property. In general, "property" for purposes of section 83 does not include money. Sec. 1.83–3(e), Income Tax Regs. However, where an option is sold or otherwise disposed of in an arm's-length transaction, section 83(a) applies to the transfer of money in the same manner as it would have

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the corresponding provisions of the option agreement, which referred to a 2-year employment period, the former would control.

[17] Cf. Rev. Rul. 73–146, 1973–1 C.B. 61; Rev. Rul. 67–366, 1967–2 C.B. 165.

Under sec. 83 and the regulations thereunder, the amount of compensation income upon disposition of an option is measured by the excess of the amount received over the amount paid, if any, for the option. See sec. 1.83–7, Income Tax Regs. The "arm's-length" requirement is intended to assure that the statutory scheme is not circumvented by means of a disposition for less than fair consideration. Cf. secs. 1.83–1(b), 1.83–1(c), and 1.421–6(a), Income Tax Regs.; *Enos v. Commissioner*, 31 T.C. 100 (1958). See generally Billman, "Nonstatutory Stock Options," 383 Tax Mgmt. A-17—A-19 (1984).

applied to the transfer of property pursuant to the exercise of the option. Sec. 1.83–7(a), Income Tax Regs. Thus, on the facts of this case, section 83(a) is to be applied as though petitioner received "property" having a fair market value of $70,000 upon the termination of the option. Since petitioner paid nothing upon either the grant or the termination of the option, his amount paid is zero. Sec. 1.83–3(g), Income Tax Regs. He must, therefore, include the full $70,000 in gross income as compensation pursuant to section 83 and the regulations thereunder.

In view of the foregoing, we hold that the $70,000 received by petitioner in exchange for the termination of the option is taxable as ordinary income, and not as capital gain.[18]

Issue 2. Consulting Fee

The second issue is whether the $50,000 consulting fee paid to petitioner by Spencer Foods is taxable to petitioner, or rather to Hereford Trading. Petitioner contends that the fee is taxable to Hereford Trading, while respondent, relying upon the assignment of income doctrine, argues that the fee is taxable to petitioner.

The assignment of income doctrine, under which income is to be taxed to the person who earned it, is a fundamental principle of the income tax law. *United States v. Basye*, 410 U.S. 441, 450–451 (1973). See *Lucas v. Earl*, 281 U.S. 111 (1930). However, as we noted in *Johnson v. Commissioner*, 78 T.C. 882, 890 (1982), affd. without published opinion 734 F.2d 20 (9th Cir. 1984), in cases involving closely held or one-man personal service corporations, a tension has evolved between the basic tenets of this doctrine and the recognition of the nature of the corporate business form. A corporation, in addition to being a separate legal entity, is a separate taxpayer for Federal tax purposes. *Moline Properties v. Commissioner*, 319 U.S. 436, 438–439 (1943). Further, it is axiomatic that a corporation can act only through its agents. *Keller v. Commissioner*, 77 T.C. 1014, 1032 (1981), affd. 723 F.2d 58 (10th Cir. 1983).

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[18] We consider our holding on this issue entirely consistent with the statutory provisions relating to qualified stock options. Those provisions allow capital gain treatment if a qualified stock option is exercised, and the stock obtained thereby held for the period prescribed by the statute. See secs. 421(a), 422(a); *Mitchell v. Commissioner*, 65 T.C. 1099, 1108–1110 (1976), affd. 590 F.2d 312 (9th Cir. 1979). Petitioner thus might have obtained capital gain treatment if he had exercised the option and held the stock so acquired for the 3-year period prescribed in sec. 422(a). Any earlier disposition of the stock, however, would have given rise to ordinary income. See sec. 421(b). Given this statutory scheme, it would be incongruous indeed "to attribute capital gain treatment to the proceeds received for the extinguishment of an option where the fruits of such option * * *, if received and translated into the same cash at that very moment, would have been treated as ordinary income." *Rank v. Commissioner*, 345 F.2d 337, 345 (5th Cir. 1965).

Lastly, we note that sec. 1234, relating to the tax treatment of certain options to buy or sell property, does not require a contrary holding. Under the general rule of sec. 1234(a)(1), the character of gain or loss upon the sale or exchange of an option is determined by reference to the character of the property subject to the option. However, this rule is inapplicable if income derived in connection with the sale or exchange of an option would, without regard to sec. 1234, be treated as other than gain from the sale or exchange of a capital asset. Sec. 1234(a)(3). Sec. 1234 does not apply to gain resulting from the sale or exchange of an option to the extent that the gain is in the nature of compensation. Sec. 1.1234–1(a), Income Tax Regs. Since the amount received by petitioner in exchange for the termination of the option is treated as compensation under sec. 83, the general rule of sec. 1234 is thus inapplicable with respect thereto. See *Kunsman v. Commissioner*, 49 T.C. 62, 68–71 (1967); *Mitchell v. Commissioner, supra*; *Rank v. United States*, 345 F.2d 337 (5th Cir. 1965); *Dugan v. United States*, 234 F. Supp. 7 (S.D.N.Y. 1964).

In resolving the issue of whether an individual or his wholly owned corporation is taxable with respect to income earned through the performance of personal services, we have held that the relevant inquiry must focus on whether the individual or the corporation controls the earning of the income. See *Johnson v. Commissioner, supra*. Under this approach, we held in *Johnson v. Commissioner, supra*, that two necessary elements must be present before the corporation, rather than its service-performer employee, will be considered the controller of the earning of the income. First, the service-performer employee must be just that—an employee of the corporation whom the corporation has the right to direct or control in some meaningful sense. Second, there must exist between the corporation and the person or entity using the services a contract or similar indicium recognizing the corporation's controlling position. See *Johnson v. Commissioner, supra* at 891, and cases cited therein.

Petitioners bear the burden of proving that respondent's determination was erroneous. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). Therefore, to establish that the $50,000 consulting fee received by petitioner is taxable to Hereford Trading, petitioners must show that the corporation controlled the earning of the consulting fee within the standard set forth in *Johnson v. Commissioner, supra*. Based upon this record, we conclude that they have failed to do so.

First, the record contains no evidence that petitioner was truly an employee of Hereford Trading and subject to its direction and control. There is, for instance, no evidence that petitioner had an employment contract or other agreement with Hereford Trading tending to establish that he was an employee of that corporation. Compare *Johnson v. Commissioner, supra* at 891–892; *Pacella v. Commissioner*, 78 T.C. 604 (1982); *Keller v. Commissioner*, 77 T.C. 1014, 1032 (1981), affd. 723 F.2d 58 (10th Cir. 1983). Similarly, there is no evidence concerning the activities and operations of Hereford Trading from which it might be inferred that such entity controlled petitioner's performance of consulting services.

Moreover, petitioners have failed entirely to show that Spencer Foods contracted with or otherwise recognized Hereford Trading in connection with petitioner's performance of consulting services. The agreement and release, pursuant to which petitioner agreed to perform consulting services, was executed only by Spencer Foods and by petitioner in his individual capacity; it made no reference to Hereford Trading. Similarly, the $50,000 check by which Spencer Foods paid for consulting services was issued to and payable to the order of petitioner, not Hereford Trading. In short, there is no evidence that Spencer Foods was even aware of the existence of Hereford Trading, or that it looked to and recognized that entity as controlling petitioner's performance of consulting services.

We conclude that petitioners have failed to carry their burden of proof with respect to this issue. Accordingly, following the principles set forth in *Johnson v. Commissioner, supra*, we hold that petitioner, and not Hereford Trading, was taxable with respect to the $50,000 consulting fee received from Spencer Foods.

To reflect the foregoing,

Decision will be entered for the respondent.

MICHAEL G. HILBORN AND HELENE A. HILBORN, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 10246-83. Filed November 5, 1985.

Ps were limited partners in S, which acquired a building located in the historic French Quarter of New Orleans. S granted to a qualified charitable organization an easement in perpetuity in the facade of the building, which grant qualified as "exclusively for conservation purposes" under sec. 170(f)(3)(B)(iii) and (C), I.R.C. 1954 (1979). *Held*, fair market value of the facade donation determined by applying the "before and after" valuation approach.

Fred R. Harbecke, for the petitioners.

John T. Lortie and *Thomas C. Borders*, for the respondent.

NIMS, *Judge*: Respondent determined a deficiency of $1,690.64 in petitioners' 1979 Federal income tax.

After concessions, the issue for decision is the fair market value of an historical facade donated to the Vieux Carre Commission of New Orleans by a limited partnership pursuant to a servitude agreement under Louisiana law.

FINDINGS OF FACT

Certain facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners Michael G. and Helene A. Hilborn (husband and wife, hereinafter sometimes referred to as petitioners) resided in Deerfield, Illinois, at the time of filing the petition herein. Petitioners are indirectly limited partners in St. Louis Partners, Ltd. (St. Louis Partners). They acquired their interest in St. Louis Partners through R & H Partners, an Illinois general partnership, of which petitioners are equal partners with Oscar Reid. R & H Partners has a 2.828-percent interest in St. Louis Partners. As 50-percent partners of R & H Partners, petitioners claimed their allowable share of losses, deductions, and credits from St. Louis Partners.

St. Louis Partners is a limited partnership with three general partners: John Nedeau, Richard Schanhals, and Bernard Wiczer (Wiczer). The purpose of the partnership was to acquire, rehabilitate, hold for investment, and operate an apartment building located at 835 St. Louis Street, New Orleans, Louisiana (the building).

The property is located on St. Louis Street near the middle of the French Quarter (Vieux Carre) of New Orleans which is a registered historic district. The French Quarter is approximately 13 blocks long and 6 blocks wide. It is bounded by the Mississippi River, Canal Street, North Rampart Street, and Esplanade Avenue. The building is situated in the square bounded by St. Louis Street, Toulouse Street, Bourbon Street, and Dauphine Street. The building is a 3½-story masonry townhouse with an attached 3-story slave quarter in the rear. At the time of the trial of this case, the building was not listed in the National Register of Historic Places in Washington, D.C., and had not been certified by the Secretary of the Interior as being of historic significance to the Vieux Carre historic district.

The property is zoned VCR-1 (Vieux Carre Residential). At the time of the facade donation, the density allowed, and the open space required, by the zoning ordinance were 3 units and 975.6 square feet, respectively. There existed at the time of donation 10 apartment units, which were later converted into 9 condominium units and 674.25 square feet of open space.

The zoning ordinance also provides in pertinent part as follows:

> No occupancy permit shall be issued by the Director, Safety and Permits, for any change in the use of any existing building until and unless a special permit shall have been issued by the Vieux Carre Commission, except that where no change of exterior appearance is contemplated such permit by the Vieux Carre Commission shall not be required. Where any change in exterior appearance is contemplated, the Vieux Carre Commission shall hold a hearing, and if it approves such change, it shall issue a special permit to continue the same use, or for any other use not otherwise prohibited in this District, subject to the following conditions and safeguards:
>
> a. The historic character of the Vieux Carre shall not be injuriously affected.
>
> b. Signs which are garish or otherwise out of keeping with the character of the Vieux Carre shall not be permitted.
>
> c. Building designs shall be in harmony with the traditional architectural character of the Vieux Carre.
>
> d. The value of the Vieux Carre as a place of unique interest and character shall not be impaired.

The Vieux Carre Commission (VCC) was created by an amendment to the Louisiana Constitution in 1936. Its purpose is stated in section 65–6, chapter 65, City Code of New Orleans, as follows:

> The Vieux Carre shall have for its purpose the preservation of such buildings in the Vieux Carre section of the city as, in the opinion of the Commission, shall have architectural and historical value and which should be preserved for the benefit of the people of the city and State.

Thus, the VCC is charged by the Louisiana Constitution and the Code of the City of New Orleans with the duty of preserving the historic character of buildings located in the French Quarter. The VCC is an organization described in section 170(c)(1).[1]

All buildings and structures fronting streets or alleys located within the Vieux Carre section of New Orleans are subject to the jurisdiction of the VCC. Before a property owner can perform any renovations to the exterior facade of a building in the Vieux Carre section, the owner must apply to the VCC for a permit. When applying for a permit, a property owner must submit plans and specifications of the proposed renovation to the VCC. The VCC has authority to specify any reasonable change to the proposed plans necessary to preserve the historic and architectural character of the building.

The written policy of the VCC, as adopted on December 4, 1979, with respect to facade donations, is as follows:

FACADE EASEMENT POLICY

> When the United States Congress enacted the 1976 Tax Reform Act legislation, which allowed for accelerated amoritization of rehabilitation costs on buildings of historic and architectural significance, it mandated procedures for both Certification of the building and any rehabilitation. Rules known as "The Secretary of the Interior's Standards for Rehabilitation" were adopted and tax benefits accrued only to those applicants who followed these preservation guidelines. The purpose is to protect the facade of historically important buildings for the public while allowing the owner a tax advantage for that which he gives to the public.
>
> However, a prospective facade donor *does not* have to have his building certified prior to making a donation for tax purposes. Although the building

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[1] Except as specifically otherwise noted, section references are to the Internal Revenue Code of 1954 in effect for 1979. All Rule references are to the Tax Court Rules of Practice and Procedure.

must be of architectural or historical importance, no formal standards have been adopted.

The standards for accepting facade donations as set forth in the VCC's Facade Easement Policy are as follows:

> Buildings located in the Vieux Carre can be considered differently. The public interest is protected to a large degree because the buildings and their existing facades are already protected by law. Therefore, a greater standard can and should be applied to a structure which applies for a facade donation. That greater standard should require restoration to prevent deterioration and to restore the building architecturally, if necessary, to a standard acceptable to the Vieux Carre Commission. Additionally, nonconforming (yet legal because they existed over two (2) years) uses, signs, or additions found to be obnoxious may be required to be eliminated. The degree of restoration will be determined by the Vieux Carre Commission on a case-by-case basis.

Thus, it was the policy of the VCC in 1979 to accept the donation of the facade of any structure in the Vieux Carre which had been historically and architecturally restored to a degree acceptable to the commission or to accept the facade donation where the plans for restoration had been approved by the commission and the work had been guaranteed by the donor.

On October 10, 1979, Wiczer, acting on behalf of St. Louis Partners, entered into a purchase agreement to acquire the building for $300,000 from a group of individuals, one of whom was Neville Landry (Landry). Landry at some time also became a limited partner in St. Louis Partners. The closing took place on November 30, 1979.

At the time of acquisition, the building was vacant and partially gutted. The $300,000 purchase price consisted of (1) an earnest money deposit of $10,000, (2) $20,000 cash at closing, (3) $30,000 cash to be paid by March 1, 1980, evidenced by a promissory note bearing 11½-percent interest, and (4) a $240,000 wraparound, nonrecourse mortgage to the seller. The contract of purchase was conditioned upon the VCC agreeing to accept a donation of the building's facade, pursuant to section 170(f)(3)(C), and the qualification of the building as a historical landmark on the Federal Register. In addition, St. Louis Partners was obligated under the contract to perform rehabilitation of the building, exclusive of facade repairs, for an amount not to exceed $185,000.

To ensure that adequate funds would be available to meet the $185,000 renovation obligation, the contract called for the establishment of an escrow fund. St. Louis Partners was required to deposit $80,000 at the time of closing with Landry Title Insurance, Inc., escrowee for the partners. Rather than naming Landry Title Insurance, Inc., as escrowee, St. Louis Partners on November 30, 1979, deposited $80,000 into account number 01–36314–2 at National American Bank of New Orleans. Wiczer and Landry were joint signatories on the account.

On December 4, 1979, the VCC voted unanimously to accept the facade donation subject to the donor's compliance with 23 recommendations written by the VCC staff and approval by the VCC of three sets of drawings (plans and elevations) incorporating the recommendations. The staff's recommendations, revised on December 7, 1979, were as follows:[2]

MAIN BUILDING

1. Repairs of front entrance and door millwork.
2. Restoration of existing wood alley gate.
3. Repair and replacement of gallery decking, soffits, and fascia boards on front facade as required to match existing.
4. Cleaning and painting of existing decorative ironwork on front facade.
5. Replacement of missing shutters and repair of existing shutters as required on front facade.
6. Removal of existing vegetation on front parapet and correction of sustaining growth condition.
7. Replacement of missing iron grille near grade on rear facade.
8. Replacement of doors and windows on rear facade with casement and paneled millwork.
9. Tuck-pointing and plastering as required on front and rear facades.
10. Painting of front, rear, and slave quarter millwork.
11. Repair of existing plaster in pedestrian alley.
12. Installation of new meter enclosure in pedestrian alley.
13. Replacement of deteriorated gutters, downspouts, and scuppers.
14. Removal of existing loose wiring and conduit.

SLAVE QUARTERS

1. Repair and/or replacement of existing balcony decking, railings, and balusters.
2. Rebuilding of existing rear stair structure, changing the direction of the first flight.
3. Repair of existing front and rear stairways.

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[2] The VCC staff recommendations as revised contain only 22 conditions of acceptance. The record does not reveal which one of the original 23 was deleted.

4. Restoration of existing door and/or window millwork.

5. Restoration of formerly-existing tongue and groove diagonal beaded board panel on ground floor to match existing.

6. Removal of existing screen doors and windows.

7. Removal of existing brick planters and planting strips in courtyard.

8. Patching of deteriorated flagstone paving in courtyard to match existing.

On December 28, 1979, St. Louis Partners entered into a servitude agreement with the VCC consisting of two documents. The agreement created a perpetual servitude on the real property which qualifies as a charitable contribution under section 170(c). A "servitude," which is a Louisiana law concept, is sufficiently analogous to an easement to permit the use of the two terms interchangeably for purposes of this case. The servitude agreement provided that certain repairs and renovations to the exterior facade of the building costing approximately $47,800 were to be made by St. Louis Partners as a condition of the VCC's acceptance of the servitude donation.

The first document, entitled "SERVITUDE," provides in pertinent part as follows:

> Grantor desires and intends and by these presents does create and establish in perpetuity, a real servitude in, over and to the exterior facade, front and roof of the above described property and the buildings and improvements located thereon, and by these presents does grant, convey and transfer in perpetuity unto Grantee, the said real servitude of the said exterior facade, front and roof of the above described property and the buildings and improvements located thereon. This real servitude shall be limited to, and shall hereinafter give Grantee, the sole right at Grantee's own discretion to preserve or maintain in its present condition (including those requirements set forth in the minutes of the meeting of the Vieux Carre Commission of December 4, 1979, the appearance, composition and/or character of the said exterior facade, front or roof of the above described property and the buildings and improvements located thereon, and/or the sole right at Grantee's own discretion to require Grantor at Grantor's sole cost and expense, to perform and conduct such work deemed necessary by Grantee in Grantee's sole discretion in order to preserve or maintain in its present condition (including those requirements set forth in the minutes of the meeting of the Vieux Carre Commission of December 4, 1979) the appearance, composition and/or character of the said exterior facade, front or roof of the above described property and the buildings and improvements located thereon. Grantee shall also have the right of ingress to and egress from any portion of the above described property, for the purposes and benefits of this servitude, and in all respects shall have such access to the

> above described property as is necessary to exercise any rights granted herein by the Grantor. Grantor shall have the right to use the above described property, including the exterior facade, front and roof which forms the subject of this servitude, for whatever lawful purpose Grantor deems necessary, except as to the rights of servitude herein granted, and agrees not to disturb Grantee in the exercise of any rights granted herein. Grantor must first obtain Grantee's written approval of and consent to any change, alteration, renovation, or improvement of, in or to the said exterior facade, front or roof before commencing such work. All work for preserving or maintaining the said exterior facade, front or roof, as may be recommended, required and/or approved by Grantee, shall be performed and conducted by Grantor at Grantor's sole cost and expense.

The second document, entitled "AGREEMENT," provides in pertinent part as follows:

> 1. Owner shall perform certain work to the above described property in accordance with the plans and specifications attached hereto and made a part hereof and marked Exhibit "B", which said work is fully described in the contract by and between St. Louis Partners, Ltd. and Herman Construction dated December 28, 1979, a copy of which is annexed hereto and marked Exhibit "C".
>
> 2. The work to be performed by Owner as shown in Exhibit "C" shall be done at Owners' sole cost and expense and shall be completed prior to May 31, 1980.
>
> 3. The Commission shall have the right to inspect Owners' work as it progresses and when it is completed and the Commission may require any changes or corrections in said work that is/are not completed pursuant to Exhibit "B".
>
> 4. Owner shall deposit the sum of Forty Seven Thousand Seven Hundred Eighty (47,780.00) Dollars in the National American Bank in New Orleans to cover the expenses of the renovation work set forth in Exhibit "B" which is the work that forms the basis of the Herman Construction contract, marked Exhibit "C", which funds shall be paid out as hereinafter provided:
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> (a) The sum of $4,778.00 on commencement of work;
>
> (b) The balance shall be paid in part by part, progressively, as the work is accomplished until the full sum of $38,224.00 is paid: and
>
> (c) The remaining $4,778.00 shall be paid when the total job is completed and approved by the Commission.
>
> 5. Other than the initial $4,778.00 payment, no funds shall be paid out of the National American Bank in N. O. account until such time as the Commission advises the Bank that the work is completed to the satisfaction of the Commission.
>
> 6. Owner agrees to deposit whatever additional funds are necessary to complete the work called for in Exhibit "C" if the Forty Seven Thousand Seven Hundred Eighty Dollars on deposit in the National American Bank in N. O. account is not sufficient to complete said work to the satisfaction of the Commission.

> 7. If the work called for in the contract by and between St. Louis Partners, Ltd. and Herman Construction, referred to herein as Exhibit "C" is not completed as of May 31, 1980 to the satisfaction of the Commission, the Commission shall be entitled to revoke and rescind the Servitude referred to herein or to enforce this Agreement by an action for specific performance.
>
> 8. This Agreement shall be binding on the parties hereto, their heirs, successors, assigns, transferees and purchasers.
>
> 9. Obligor shall at all times carry adequate property and liability insurance for the Property, including the exterior facade, front and roof, at his sole cost and expense. Any damage occurring to the Property, including the exterior facade, front or roof, shall be promptly repaired by Obligor at his sole cost and expense. Vieux Carre Commission shall not be liable to Obligor or any third person for any use, including the performance of and work thereon of the Property, including the exterior facade, front or roof. Obligor shall indemnify, hold harmless and provide a complete legal defense to Vieux Carre Commission for any liability which may arise from any use, including the performance of any work thereon on the Property, including the exterior facade, front or roof.
>
> It is understood and agreed that the rights, interests, obligations and benefits herein constitute a real servitude in perpetuity and is and shall be binding on Grantor, his heirs, successors and assigns, and on all subsequent owners of the above described property and any buildings and improvements located thereon.

The two documents were executed simultaneously and, as previously stated, together constitute the servitude at issue. Both documents were recorded in the land records of New Orleans.

To pay the expenses incurred for the facade renovations, a second escrow account was established at National American Bank of New Orleans (National American) on December 28, 1979. Funding of the account was accomplished by way of a $48,000 withdrawal from National American account number 01-36314-2 and deposit of the same amount in National American account number 01-36353-3. The joint signatories on this second account were Landry and Henry M. Lambert, director of the VCC. With the exception of the $48,000 to establish the second bank account, no withdrawals were made in 1979 from either account at National American.

During 1980 and 1981, St. Louis Partners paid $239,596.52 to renovate and convert the interior of the building into nine condominium units, eight of which were subsequently sold or otherwise disposed of by the partnership. In addition, $47,780 was paid by St. Louis Partners to renovate and repair the facade of the building during the same 2 years. Only minimal work on the facade was done in 1979.

To establish the proper fair market value for the donated servitude, petitioners and respondent each presented the testimony of an expert witness. Jared Shlaes testified for petitioners and Max J. Derbes, Jr., testified for respondent.

Petitioners' expert witness, Jared Shlaes (Shlaes), is a member of the Appraisal Institute and is a member of the Easement Valuation Panel of Appraisers for the National Trust for Historic Preservation and is qualified to give an opinion as to the value of real estate. Shlaes practices primarily in the Chicago metropolitan area. Prior to his testimony in this case, Shlaes had never appraised any real estate property in the French Quarter of New Orleans or anywhere in New Orleans. Petitioners did not submit a written expert report. Shlaes testified orally as to his opinion regarding the fair market value of the facade servitude. Shlaes determined the fair market value of the facade servitude on December 28, 1979, to be $94,000.

Respondent's expert witness, Max J. Derbes, Jr. (Derbes), is a member of the Appraisal Institute (MAI) and the American Institute of Real Estate Appraisers (AIREA) and is qualified to give an opinion as to the value of real estate. He has performed real estate appraisals in New Orleans since 1946 and is familiar with real estate in the French Quarter of New Orleans. Derbes performed an appraisal of the building and prepared a detailed written report of his opinion regarding the value of the facade servitude donated to the VCC. Derbes determined the fair market value of the facade servitude donated on December 28, 1979, to be $24,500, exclusive of rehabilitation work to be performed after 1979. Alternatively, Derbes determined the fair market value to be $53,500, inclusive of rehabilitation work to be performed after 1979.

OPINION

Petitioners have an interest in St. Louis Partners, a limited partnership, by reason of being partners in a partnership which itself is a limited partner in St. Louis Partners. St. Louis Partners was formed for the purpose of acquiring, rehabilitating, holding for investment, and operating an apartment building located at 835 St. Louis Street, New Orleans, Louisiana. The building, which was vacant and partially gutted at the time of its acquisition, is located in the French Quarter of New Orleans, a historic district under the control of the Vieux Carre Commission (VCC).

On November 30, 1979, St. Louis Partners purchased the building for $300,000. The purchase contract was conditioned upon the VCC agreeing to accept a donation of the building's facade pursuant to section 170(f)(3)(C)[3] and the partnership's agreeing to expend up to $185,000, exclusive of facade repairs, to rehabilitate the property. On December 28, 1979, St. Louis Partners donated the facade to the VCC by granting a servitude in perpetuity under Louisiana law. The servitude, for purposes of this case, is deemed to be the equivalent of a common law easement in perpetuity. The servitude agreement was created by two documents, each of which was itself an agreement between St. Louis Partners and the VCC, one entitled "SERVITUDE" and the other entitled "AGREEMENT."

The servitude agreement and the VCC's conditions for acceptance of the facade donation imposed substantial obligations and restrictions upon St. Louis Partners as owners of the property. The VCC staff recommendations, to which the partnership was required to accede, covered repairs and rehabilitation work on the outside of the entire main building as well as the slave quarters. In this connection, the partnership was required to place $47,780 in escrow to cover the cost of this work, all of which money was subsequently spent.

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[3] Sec. 170(f)(3) was amended by sec. 6(a), Pub. L. 96-541, 94 Stat. 3206, effective for transfers made after Dec. 17, 1980, in taxable years ending after that date. For certain years, including 1979, sec. 170(f)(3) provided:

> (3) DENIAL OF DEDUCTION IN CASE OF CERTAIN CONTRIBUTIONS OF PARTIAL INTERESTS IN PROPERTY.—
>
> (A) IN GENERAL.—In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowable as a deduction under this section if such interest has been transferred in trust. For purposes of this subparagraph, a contribution by a taxpayer of the right to use property shall be treated as a contribution of less than the taxpayer's entire interest in such property.
>
> (B) EXCEPTIONS.—Subparagraph (A) shall not apply to a contribution of—
>
> (i) a remainder interest in a personal residence or farm,
>
> (ii) an undivided portion of the taxpayer's entire interest in property,
>
> (iii) a lease on, option to purchase, or easement with respect to real property granted in perpetuity to an organization described in subsection (b)(1)(A) exclusively for conservation purposes, or
>
> (iv) a remainder interest in real property which is granted to an organization described in subsection (b)(1)(A) exclusively for conservation purposes.
>
> (C) CONSERVATION PURPOSES DEFINED.—For purposes of subparagraph (B), the term "conservation purposes" means—
>
> (i) the preservation of land areas for public outdoor recreation or education, or scenic enjoyment;
>
> (ii) the preservation of historically important land areas or structures; or
>
> (iii) the protection of natural environmental systems.

The servitude agreement also gave the VCC very substantial control over the entire exterior of both the main building and the slave quarters. Without question, there is a certain amount of overlap between the facade control ceded to the VCC by the servitude agreement and the control inherently vested in the VCC by the provisions of the Louisiana Constitution dealing with the historic preservation of the Vieux Carre and various statutes and municipal zoning ordinances enacted in furtherance thereof. Unquestionably, however, the partnership by the facade donation also voluntarily relinquished substantial flexibility in the use of the property and committed itself to the expenditure of substantial funds which it otherwise would not have been required to make.

It is also significant that in connection with the purchase of the property, the partnership was obligated to perform rehabilitation of the building, exclusive of facade repairs, for an amount not to exceed $185,000. Although the record is not clear on this point, the rehabilitation expenditure commitment was apparently required by the sellers to insure performance of certain obligations of their own. As a matter of fact, the partnership ultimately spent $239,596.52, rather than the $185,000 to which the partnership was committed under the purchase and sale agreement. The $239,596.52 was spent to renovate and convert the interior into nine condominium units and was over and above the approximately $47,800 spent to renovate and repair the facade.

The parties agree that the facade donation qualified as a real property easement in perpetuity for conservation purposes under section 170(f)(3)(B)(iii), as in effect for 1979 (see discussion *infra*), and as a charitable contribution to the VCC under section 170(c)(1). Neither party has raised a question as to whether there might not have been an incompleted gift in 1979 because of the conditions on its acceptance imposed by the VCC. Therefore, the only issue to be decided is the fair market value of the facade donation on December 28, 1979. In this connection, it is conceivable that both parties tacitly proceed on the assumption that the partnership was irrevocably committed to comply with the conditions for acceptance dictated by the VCC, so that the facade donation was, in fact, a completed gift in 1979. Petitioners' expert expressed the opinion that the fair market value of the gift was $94,000, although, on brief, petitioners assert a value of $108,400. Respondent contends that the fair market value was $24,500.

Section 1.170A-1(c)(1), Income Tax Regs., provides that if a contribution is made in property other than money, the amount of the deduction is determined by the fair market value of the property at the time of the contribution. The fair market value, according to the regulations, is the price at which the property would exchange hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. Sec. 1.170A-1(c)(2), Income Tax Regs.; see *Thayer v. Commissioner,* T.C. Memo. 1977-370 (value of open space or scenic easement determined).

For certain years (including 1979) ending before December 18, 1980, a charitable contribution deduction was allowed for a perpetual easement donated to a qualified charitable organization if the donation was "exclusively for conservation purposes." Sec. 170(f)(3)(B)(iii) (1979 version). The term "conservation purposes" was defined in section 170(f)(3)(C) to include:

> (i) the preservation of land areas for public outdoor recreation or education, or scenic enjoyment;
> (ii) the preservation of historically important land areas or structures; or
> (iii) the protection of natural environmental systems.

No established market existed to which one might refer directly to determine the fair market value of the easement. As in *Thayer v. Commissioner, supra,* the parties agreed that the only feasible method of valuing the easement was by measuring the difference between the fair market value of the property immediately before the easement was granted and the fair market value of the property immediately after the easement was granted. Stated another way, the question becomes: what was the difference, if any, in the value of the property with and without the easement?

This approach was apparently approved by Congress in connection with the 1980 amendments to section 170(f)(3), referred to above (Pub. L. 96-541, sec. 6(a), 94 Stat. 3206), although the Senate report issued in connection therewith states that "Where this test is used, however, the committee believes it should not be applied mechanically." S. Rept. 96-1007 (1980), 1980-2 C.B. 599, 606.

The before and after approach is also the one recommended in "Appraising Easements—Guidelines for Valuation of Historic Preservation and Land Conservation Easements" (October 1984), a document (of which we took judicial notice at the trial) prepared by the National Trust for Historic Preservation and the Land Trust Exchange. The Internal Revenue Service has also approved use of the before and after method. See Rev. Rul. 73-339, 1973-2 C.B. 68, and Rev. Rul. 76-376, 1976-2 C.B. 53.

Before discussing the expert testimony offered by petitioners and respondent, it is helpful to summarize certain general principles of easement valuation which have guided our decision in this case.[4] Initially, our objective is to determine whether, and to what degree, the easement changes the use and value of the property. As its name implies, the before and after method accomplishes this objective by subtracting the value of the property immediately after the imposition of the easement from the value of the property immediately before the imposition of the easement to estimate the value of the easement.

"Before" value (before value) is arrived at by first determining the highest and best use of the property in its current condition unrestricted by the easement. At this stage, the suitability of the property's current use under existing zoning and market conditions and realistic alternative uses are examined. Any suggested use higher than current use requires both "closeness in time" and "reasonable probability." Next, to the extent possible, the three commonly recognized methods of valuing property (capitalized net operating income, replacement cost, and comparable sales) are used, but are modified to take into account any peculiarities of the property which impact on the relative weight to be afforded each respective method.

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[4] See National Trust for Historic Preservation and the Land Trust Exchange, "Appraising Easements—Guidelines for Valuation of Historic Preservation and Land Conservation Easements" (October 1984).

"After" value (after value) is arrived at by first determining the highest and best use of the property as encumbered by the easement. At this stage the easement's terms and covenants are examined, individually and collectively, and compared to existing zoning regulations and other controls (such as local historic preservation ordinances) to estimate whether, and the extent to which, the easement will affect current and alternate future uses of the property. Next, the above-mentioned three approaches to valuing property are again utilized to estimate the value of the property as encumbered by the easement.

With these general principles in mind, we now examine the respective expert testimony offered by the parties.

Jared Shlaes (Shlaes)

Petitioners' expert, Shlaes, utilized the before and after method of valuation. With respect to the before value, Shlaes considered the size and shape of the property, its location in the French Quarter, its comparative value in relation to the adjacent corner property as well as several other comparables, its zoning, its apparent condition in 1979, and its highest and best use. In addition, Shlaes reviewed the purchase contract, inspected the property, investigated the area, and accounted for the $80,000 escrow created at the time of purchase for future rehabilitation.

Applying a market data approach and using several properties listed in an appraisal report compiled by Derbes, as well as the corner lot adjacent to the building, Shlaes determined the value of the land to be $98,000 or $30 per square foot of land area. He further determined in a test calculation the value of the improvements, prior to rehabilitation, to be $214,000. Shlaes concluded that his analysis supported the stated contract price of $300,000. To this he added the $80,000 escrowed for future rehabilitation because he determined the purchasers to be irrevocably obligated, bringing the total before value to $380,000.

With respect to after value, Shlaes concluded that the market data approach and the income approach could not be utilized. Furthermore, the cost approach offered only an "extremely tenuous indication" of value. Thus, he concluded that his subjective judgment was the only basis upon which to determine the after value.

In making this judgment, Shlaes focused on the differences between the easement granted and the existing zoning laws and ordinances as well as the authority of the VCC. His purpose was to determine what, if any, additional burdens were imposed on the property as a result of granting the easement. He concluded that the easement created "substantial additional burdens."

Shlaes determined the highest and best use of the property to be "rehabilitation with some possibility of eventual conversion to condominium or merger with the corner property to do some sort of combined development." Shlaes accorded great weight to his finding that the easement prevented assemblage with the corner lot and therefore restricted the highest and best use of the property.

Moreover, Shlaes found the easement to require major rehabilitation which imposed added problems for the owners. For instance, additional problems were associated with rehabilitation, getting permits for construction, and finding craftsmen who could do the quality work required by the VCC. The owners' ability to obtain construction financing and permanent financing for subsequent purchasers of the condominium units was also adversely affected by the easement, according to Shlaes. In addition to the added burdens already listed, Shlaes concluded that sales resistance and market resistance of any buyers would be increased due to the newness of historic preservation easement donation programs. He reasoned:

> Nobody could know how the commission would enforce its right against the donor. Nobody could know how the court decisions would go about those rights, and nobody could measure the interference with the redevelopment of the property that might be asserted by the donee, so there was a substantial interference with the owner's position.

Other factors analyzed by Shlaes in ascertaining the after value of the property included the location, market timing, use, age, and condition of the building. After compiling and analyzing the information which he deemed relevant, Shlaes concluded that the additional burdens imposed by the easement resulted in a 12-percent diminution in value of the property. Converted into a dollar figure, the 12-percent diminution equaled approximately $46,000.[5]

Finally, Shlaes determined that the obligation to rehabilitate the facade as a condition of the VCC accepting the donation was beyond what normal rehabilitation would entail in the French Quarter. Therefore, Shlaes concluded that the $48,000[6] burden imposed by the easement in effect amounted to a further devaluation of the property after the easement. Thus, Shlaes determined the total value of the easement to be $94,000.

To summarize, the numerical computations performed by Shlaes were as follows:

$300,000 – stated contract price
+ 80,000 – amount escrowed for future rehabilitation
380,000
× 0.12 – percent of diminution
46,000 – diminution value rounded to nearest $1,000
+ 48,000 – amount escrowed for future facade repairs
94,000 – fair market value of easement

Max Derbes (Derbes)

Respondent's expert, Derbes, utilized the before and after method of valuation. With respect to before value, Derbes considered the highest and best use of the property, its location, size, shape, condition, and existing restrictions.

Derbes defined the highest and best use of the property as "that use which at the time of appraisal is most likely to produce the greatest net return to the land and/or building over a given period of time." According to Derbes, this use must be logical, likely, reasonably probable, and proximate, and not such as is merely possible.

Derbes examined factors such as size, location, neighborhood character, trend of development, and the relevant zoning ordinance in arriving at his determination of highest and best use. He concluded that the highest and best use of the property was as residential rental units with the potential for conversion to condominiums.

Derbes then applied four separate approaches of valuation to estimate the before value of the property: the market data, modified cost, income, and utilization as a condominium project. The market data approach utilized involved an analysis of recent sales and offerings of similar properties in the general area (although none were found in the Vieux Carre itself). In addition, Derbes researched and compared sales of unimproved land in the Vieux Carre. This enabled Derbes to estimate not only the value of the subject site but also the land value of the improved comparable sales to indicate net unit value of the buildings. Derbes concluded after analysis of the sales data that the unimproved land value of the property was $23.06 per square foot, or $75,000.[7]

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[5] The actual figure is $45,600 computed as follows: $380,000 × 0.12.

[6] The actual figure is $47,780.

Derbes then analyzed comparable sales of improved properties, factoring in the land value as determined. His analysis considered the sale price, date of sale, number of units, gross building area, price per square foot, individual unit prices, extent of renovation, and quality of renovation. He estimated value through four separate computational methods: gross price/square foot method, price/unit method, breakdown method, and gross rent method. The resulting values ranged from a high of $325,000 to a low of $286,000. Derbes concluded that the breakdown method provided the most reliable indicator of value, computed as follows:

Estimated contributory value of buildings 7,167 sq. ft. gross building area × $31.00/sq.ft. ..	$222,177
Estimated contributory value of carriageway, balconies, patio, site improvements	20,000
Plus: Estimated land value...............................	75,000
Indicated value via breakdown method	317,177

Derbes then utilized a modified cost approach of valuation which entailed utilization of the acquisition price of the building as well as expenditures made on the property. The classical cost approach (involving reproduction cost) was deemed inapplicable by Derbes because of the property's age, construction quality, and physical depreciation. The underlying assumption of the modified cost approach is that the property is worth the sum total of what the purchaser paid plus the cost of existing improvements. An additional increment may be added because of other costs and associated appreciation.

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[7] The actual value is $74,991.12 computed as follows: 3,252 sq. ft. × $23.06.

Derbes computed the value of the property pursuant to the modified cost approach as follows:

Acquisition price	$300,000
Increment for closing costs, interest, etc	20,000
Total indicated value	320,000

Derbes determined that it was unnecessary to make a subjective time adjustment to account for appreciation since the date of valuation (the donation date) was shortly after the acquisition date. Moreover, since no improvements were made prior to the date of donation, no upward adjustment was necessary.

Next, Derbes utilized a classical income approach which entailed research and analysis of rental and expense data to arrive at an estimated value of the property. The gross income and net operating income are established by comparing the subject property with other buildings of similar usage presently leased. In addition, expenses and rental income information were obtained from the prior owners.[8] Net operating income is determined by subtracting total expenses from gross income. Then net income is converted into a value figure by applying a capitalization rate to the income figure.

Based upon prevailing market rates in the area, and Derbes' understanding of the property's relative place in the market, Derbes determined the applicable capitalization rate to be 5.5 percent.[9] Derbes then computed the property's value based on an income method of valuation as follows:

Gross potential income ($2,200/mo. × 12 months)	$26,400
Less: Vacancy and credit allowance (5 percent)	1,320
Effective gross income	25,080
Less: Total expenses	10,050
Net operating income	15,030

Net operating income divided by capitalization rate = Value
($15,030 ÷ .055 = $273,273)

Derbes also examined the before value of the property with reference toward development of the property as a condominium project. This method entailed an analysis of comparable condominium projects in the area to arrive at a price per square foot that could be achieved if the property was sold as individual condominium units. Derbes determined the average price per square foot obtainable to be $125. Derbes' calculations assume that the total costs incurred subsequent to the date of donation, including those for the exterior facade, would have needed to have been spent in order to realize the unit price of $125 per square foot.

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[8] Approximately 1 year prior to the sale of the building, the former tenants moved and the building was vacant and then gutted. Landry estimated that gross monthly rent before the tenants moved was approximately $2,200 per month. Derbes used this figure in computing gross income.

[9] The written report at one point indicates a 7-percent capitalization rate but subsequently uses a 5.5-percent rate. Application of a 7-percent rate would result in a $214,715 value.

Derbes then calculated value as follows:

Estimated retail market value of units 5,421 S.F. × $125.00/S.F.		$677,625.00
Costs		
Legal, accounting, etc.	$10,000	
Financing cost and interim interests	30,000	
Marketing and advertising	45,000	
Total costs		85,000.00
Net to real estate promoter		592,625.00
Profit to promoter (including risk)		80,000.00
Indicated value of real estate with improvements made after 1979 being considered		512,625.00
Less: Facade, building and condominium renovation		287,396.52
Indicated value of property as of the date of donation		225,228.48

With respect to three of the before value approaches utilized (modified cost, use as a condominium project, and market data), Derbes also estimated the value of the property with the improvements. However, Derbes' final determination as to market value is based on the premise that improvements made after the date of donation should not be factored into the calculation since market value is to be determined as of the time of donation.

Derbes concluded that the modified cost approach and the market data approach are the most reliable indicators of value. After correlating all the information involved in his analysis, Derbes concluded that the market value of the property before the date of donation was $320,000.

Derbes next estimated the value of the property after the donation. This step of his analysis entailed an examination of the servitude itself to determine what, if any, additional burdens are imposed on the property owners as a result of the servitude.

Derbes considered the current use of the property as well as the highest and best use of the property given the likelihood of development absent the restrictions imposed by the easement. The VCC's facade easement policy and existing zoning restrictions were also accounted for by Derbes. Certain additional limitations were also considered, such as the VCC's right to require the owner to perform work on the property, order materials or workmanship more costly than the owner would otherwise elect, and require the work to be done at a time when the owner might not want to make capital expenditures.

In addition, Derbes evaluated the servitude's impact on value because of the VCC's insurance requirement, its right of ingress and egress, the requirement that the VCC's written approval and consent be given for any change, alteration, renovation, or improvement to the facade or roof, and the fact that the easement is granted in perpetuity. Derbes examined the relative positions of the VCC, the city, and the property owner, as well as buyer motivation, the nature of the local market, and the impact the servitude could have upon mortgage lending policies.

After considering all of the factors delineated above, Derbes concluded that the easement grant resulted in diminution in market value of 10 percent. Therefore, Derbes determined after value of the property to be $295,500, computed as follows:

Before value	=	$320,000
Less land value	=	75,000
Improvement value	=	245,000
Diminution percent	=	0.1
Diminution value	=	24,500
Before value	=	320,000
Less diminution value	=	24,500
After value	=	295,500

The $24,500 difference between before value and after value is Derbes' determination of the fair market value of the easement donated to the VCC on December 28, 1979.

Derbes then attempted to verify the 10-percent diminution in value figure with what little market data he could obtain. He conducted an empirical study of properties located in metropolitan New Orleans encumbered by easements. An in-depth examination of the sales history of each property so encumbered was conducted and then compared with the sales history of a number of similar properties which were not

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encumbered by easements. The available data were limited to three cases in which a sale of property had occurred subsequent to the facade donation.

Derbes' analysis indicated that two of the properies sold did not suffer any measurable diminution in value because of the facade donation. However, the other property examined indicated a 9-percent diminution in value as a result of the easement.

A final analysis performed by Derbes involved an examination of eight condominium projects in the French Quarter, including the one here at issue. The purpose was to determine what, if any, impact the facade donation had on subsequent sales of the individual condominium units. Only two of the eight projects examined involved facade donations. Derbes concluded from the data examined that there was no discernable difference between the adjusted unit values for those units in complexes with donated facades as opposed to units in complexes where the facades had not been donated. Derbes did, however, qualify this assessment by recognizing the potential for minor errors resulting from subjective judgments necessitated by the lack of similarity between projects. Derbes concluded that the empirical study conducted, although based on limited data and certain subjective judgments, tended to support his determination that the easement resulted in a 10-percent diminution in value.

At respondent's request, Derbes also valued the easement taking into account the value of renovations which occurred subsequent to the date of the facade donation. The post-donation expenditures of $287,396.52[10] are estimated to have added $287,400 to the value of the property. As noted earlier, the $24,500 valuation gives no credit for renovations made to the property in 1980 and 1981. Applying the prior analysis but giving credit for post-donation renovations, Derbes determined the value of the easement to be $53,500 computed as follows:

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[10] This figure consists of $239,596.52 for interior renovation and $47,800 for facade renovation.

Before value = $610,000
Less land value = 75,000
Improvement value = 535,000
Diminution percent = 0.1
Diminution value = 53,500
Before value = 610,000
Less diminution value = 53,500
After value = 556,500

The $53,500 difference between before value and after value is Derbes' alternative determination of the fair market value of the easement donated to the VCC, on December 28, 1979, based upon credit being given for post-donation expenditures and exclusion of land value.

We have carefully examined the expert testimony of both Shlaes and Derbes, the detailed written report of Derbes, and the entire record before us. In spite of the disparity between the experts' ultimate valuation conclusions, close scrutiny of their respective analysis indicates a substantial degree of agreement. Both experts utilized the before and after approach and both experts believed the market data approach to be a reliable indicator of before value. Moreover, Shlaes and Derbes both analyzed the elements of the servitude agreement to determine the impact, if any, it had on after value. In resolving the valuation question before us, we have drawn on each expert's testimony, eliminating certain conclusory elements we believe to be erroneous.

With respect to the servitude's impact on value, Shlaes determined that a 12-percent diminution in value resulted from the servitude grant. Specifically, Shlaes opined that substantial burdens were added to the property. Derbes, on the other hand, concluded from his analysis that the additional burdens resulting from the servitude were only minimal, but nevertheless was willing to concede that a 10-percent diminution is reasonable.

In general, we find Derbes' methodology more convincing than that of Shlaes, although we think the ultimate value to be placed on the facade donation must reflect certain of Shlaes' conclusions. For example, we agree with Shlaes that the easement created more substantial additional burdens than Derbes was willing to concede, for the reasons contained in the foregoing summary of Shlaes' testimony. However, we think these additional burdens are, in fact, adequately reflected in the 10-percent diminution factor determined by Derbes. Shlaes conceded that his 12-percent figure was wholly subjective. Derbes, on the other hand, arrived at an objective 10-percent figure in the manner we have previously described. We therefore accept Derbes' 10-percent figure.

We also agree with Shlaes and part company with Derbes in Shlaes' belief that land value, being an integral part of improved real estate, cannot be factored out in determining before and after value.

As we previously observed, no question has been raised about the facade donation being a completed gift in 1979. Derbes stated that in arriving at his principal valuation figure of $24,500 he disregarded the rehabilitation and renovations performed subsequent to the property's acquisition by the partnership. We think this was erroneous. If the facade donation had become a completed gift only in the year in which the rehabilitation and facade renovation was finished, then Derbes would have taken these items into account. But since we are proceeding upon the assumption that the partnership was irretrievably out of pocket, because of its commitment under the purchase and sale agreement and the servitude agreement, to spend an amount not to exceed $185,000 for rehabilitation, and $47,780 for facade renovations, we think these amounts must be added to the value of the property, both for before value and after value purposes. In further support of this, we would add that at the time the property was acquired by the partnership the likelihood that its renovation costs would be any less than $185,000 was so remote as to be negligible. This was duly born out by the $239,596.52 actually spent in 1980 and 1981. These figures become significant, of course, in applying Derbes' 10-percent servitude diminution figure which, as already stated, we accept.

Thus, we conclude that it is appropriate to modify Derbes' alternative determination in the following manner:

Before value		
Cost of property (includes land)	$320,000	
Rehabilitation commitment	185,000	
Facade renovation	47,780	
Total		$552,780
Times: Diminution percent		0.1
Diminution value		55,278
Before value		552,780
Less: Diminution value		55,278
After value		497,502

On the foregoing basis we find the value of the facade donation to be $55,278.

On brief, petitioners assert a facade donation value of $108,400, rather than Shlaes' $94,000, to take into acount $20,000 of indirect acquisition costs allowed by Derbes but not taken into account by Shlaes. Petitioner computed the $108,400 figure as follows:

Acquisition cost		
Per contract	$300,000	
Indirect costs	20,000	
Rehabilitation commitment	185,000	
Total acquisition cost		$505,000
Times: Percentage diminution		0.12
Unadjusted value of facade donation		60,600
Plus: Renovation expenses		47,800
Value of facade donation		108,400

Thus, petitioners apply their 12-percent diminution to the cost of the rehabilitated property (land and building) to determine what we have denominated as "unadjusted facade donation," and to this figure have added the $47,800 facade renovation cost to which the partnership was committed. We believe, however, that if the land is an integral part of the property for valuation purposes, then likewise the renovated facade is also an integral part of the property. Thus, we conclude that the facade renovation cost of $47,780 must be included in the before value of the property to reflect the total before value of $552,780, against which Derbes' 10-percent percentage diminution, rather than Shlaes' 12 percent, is to be applied.

To reflect the foregoing and prior concessions,

Decision will be entered under Rule 155.

THE HONGKONG AND SHANGHAI BANKING CORPORATION, PETITIONER *V.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 4075–80. Filed November 5, 1985.

Petitioner (P) is a Hong Kong corporation primarily engaged in the banking business, worldwide. During the years in issue, P had assets and operations in virtually every western nation, including U.S. branch offices in New York, Chicago, and Seattle. P timely filed Forms 1120F (U.S. Income Tax Return of a Foreign Corporation) for the years 1974, 1975, and 1976. Upon audit of the returns, the Commissioner (R) disallowed certain interest and office administrative deductions for lack of substantiation on the ground that R's agents had been denied access to P's original books and records in Hong Kong. R filed a motion under sec. 7456(b), I.R.C. 1954, to require P to produce in the Tax Court certain of P's books and records for the years in issue. *Held*: R's motion is granted, upon terms. The criteria for the scope of a sec. 7456(b) order are: that the investigation is to be conducted pursuant to a legitimate purpose, that the inquiry must be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the procedural steps required by sec. 7456(b) must be followed. *United States v. Powell*, 379 U.S. 48 (1964), applied.

Paul A. Teschner, for the petitioner.

Thomas C. Borders and *Andrew P. Fradkin*, for the respondent.

OPINION

NIMS, *Judge*: This matter is before the Court on respondent's motion for an order under section 7456(b)[1] to require petitioner to produce in Court certain books and records located in its home office in Hong Kong. Respondent determined deficiencies in petitioner's Federal income tax as follows:

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954. All Rule references are to the Tax Court Rules of Practice and Procedure.

Year ended Dec. 31—	*Deficiency*
1972	$38,651
1975	142,156

The deficiencies result from adjustments made by respondent on petitioner's 1974, 1975, and 1976 Forms 1120F returns.

Two issues[2] remaining in the case which are relevant to the motion under consideration are (1) whether petitioner is entitled to an interest expense deduction taken in the amount claimed for 1976; and (2) whether petitioner is entitled to allocate indirect expenses of the head office in Hong Kong to the U.S. branches in the amounts claimed for 1974, 1975, and 1976.

Petitioner is a Hong Kong corporation primarily engaged in the banking business, worldwide. During the years in issue, petitioner had U.S. branch offices in New York, Chicago, and Seattle. It also had assets and operations in most western nations throughout the world. Foreign corporations which earn income which is effectively connected with the conduct of a trade or business within the United States must report annually on Form 1120F, U.S. Income Tax Return of a Foreign Corporation. Petitioner timely filed Forms 1120F for its taxable years 1974, 1975, and 1976.

Petitioner computed its U.S. income taxes for 1974, 1975, and 1976 based upon worldwide gross income, gross income from sources within the United States (effectively connected income), the percentage of worldwide income which constituted effectively connected income, the total worldwide head office administrative expenses, and the head office administrative expenses allocable to effectively connected income, respectively, as follows:

	1974	*1975*	*1976*
A. U.S. effectively connected gross income	$8,726,348	$5,878,593	$6,024,027
B. Worldwide gross income	534,661,745	515,149,915	457,777,116

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[2] A third issue remaining in the case involves the disallowance of a management consulting fee claimed as a deduction for 1976. However, books and records located in Hong Kong are not relevant to this issue.

	1974	1975	1976
C. A divided by B	1.632%	1.1141142%	1.315930%
D. Worldwide head office administrative expenses	$8,931,824	$14,705,847	$10,899,214
E. Head office administrative expenses allocated to the U.S.	145,767	167,815	143,426

In addition, petitioner claimed an interest expense deduction of $6,332,249 in computing its U.S. income taxes for 1976 as follows:

Item	12/31/75	12/31/76	Average
A. Worldwide assets	$6,050,808,676	$7,353,794,108	$6,702,301,392
B. U.S. effectively connected assets	210,185,789	191,764,620	
Less:			
Inter-branch balances	(62,184,219)	(23,448,701)	
Net:			
U.S. effectively connected assets	148,001,570	168,315,919	158,158,745
C. Worldwide interest expense		268,342,031	

D. $\frac{B}{A} \times C =$ Interest expense allocated to U.S. operations, namely:

$$\frac{\$158,158,745}{\$6,702,301,392} \times \$268,342,031 = \underline{\$6,332,249} \text{ (interest expense deduction)}$$

Respondent's Office of International Operations audited petitioner's Forms 1120F for 1974, 1975, and 1976. During the course of the audit, respondent's agent requested the right to inspect the books and records maintained at petitioner's home office in Hong Kong. This request was refused.

Respondent alleges in his moving papers that:

> Petitioner's position at the audit was that substantiation for the disputed deductions would be provided by statements of the Head Office charges account verified by reports and statements certified by Certified Public Accountants retained by petitioner in the ordinary course of its business. To date, petitioner has not modified its position and continues to maintain that its books and records are sacrosanct.

Petitioner's multipart response to respondent's motion may be fairly summarized as follows:

(1) Respondent should simply identify the books and records located in Hong Kong which respondent deems relevant in this case, and thereafter it would be sufficient for petitioner merely to produce the specifically identified books and records. Respondent need not be allowed to examine petitioner's books and records of original entry in Hong Kong.

(2) Respondent changed his position regarding the reason for disallowance of the interest expense deduction after a so-called 30-day letter was sent to petitioner. In the deficiency notice, respondent based the disallowance merely on lack of substantiation, whereas the earlier disallowance gave other reasons.

(3) Respondent refused to discuss settlement on any basis because of petitioner's refusal of access to its books and records.

(4) Petitioner's head office books and records are replete with trade secrets and highly confidential aspects of its worldwide banking business. Also, unlike the United States, which has a Freedom of Information Act and where taxpayer records are otherwise on occasion made available to third parties, it is the unwavering policy of Hong Kong to guarantee that all taxpayer records shall remain inviolate. Section 4 of chapter 112 (Inland Revenue Ordinance) of the Laws of Hong Kong provides in part as follows:

> Official secrecy.
>
> 4. (1) Except in the performance of his duties under this Ordinance, every person who has been appointed under or who is or has been employed in carrying out or in assisting any persons to carry out the provisions of this Ordinance shall preserve and aid in preserving secrecy with regard to all matters relating to the affairs of any person that may come to his knowledge in the performance of his duties under this Ordinance, and shall not communicate any such matter to any person other than the person to whom such matter relates or his executor or the authorized representative of such person or such executor, nor suffer or permit any person to have access to any records in the possession, custody or control of the Commissioner. (Amended, 9 of 1958, s.3)

(5) This case should be governed by section 982[3] rather than section 7456(b).

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[3] Sec. 982(a), which states the general rule, provides:

SEC. 982(a). GENERAL RULE.—If the taxpayer fails to substantially comply with any formal document request arising out of the examination of the tax treatment of any item (hereinafter in this section referred to as the "examined item") before the 90th day after the date of the mailing of such request on motion by the Secretary, any court having jurisdiction of a civil proceeding in

(6) If petitioner were a U.S.-based company, the question of substantiation of the questioned deductions would have been resolved without litigation. Therefore, "it might be in the best interest of all concerned if this case could be limited to the two legal questions at issue, to wit: (1) Is Petitioner entitled to use the 'fungibility' method of computing its interest expense deduction for 1976; and (2) Does Petitioner's Marine Midland stock constitute an investment or is it effectively connected with Petitioner's United States Business?"

Section 7456(b) was new with the 1954 Code and has remained unchanged since the date of enactment. It provides:

> SEC. 7456(b). PRODUCTION OF RECORDS IN THE CASE OF FOREIGN CORPORATIONS, FOREIGN TRUSTS OR ESTATES AND NONRESIDENT ALIEN INDIVIDUALS.—The Tax Court or any division thereof, upon motion and notice by the Secretary, and upon good cause shown therefor, shall order any foreign corporation, foreign trust or estate, or nonresident alien individual, who has filed a petition with the Tax Court, to produce, or, upon satisfactory proof to the Tax Court or any of its divisions, that the petitioner is unable to produce, to make available to the Secretary, and, in either case, to permit the inspection, copying, or photographing of such books, records, documents, memoranda, correspondence and other papers, wherever situated, as the Tax Court or any division thereof, may deem relevant to the proceedings and which are in the possession, custody or control of the petitioner, or of any person directly or indirectly under his control or having control over him or subject to the same common control. If the petitioner fails or refuses to comply with any of the provisions of such order, after reasonable time for compliance has been afforded to him, the Tax Court or any division thereof, upon motion, shall make an order striking out pleadings or parts thereof, or dismissing the proceeding or any part thereof, or rendering a judgment by default against the petitioner. For the purpose of this subsection, the term "foreign trust or estate" includes an estate or trust, any fiduciary of which is a foreign corporation or nonresident alien individual; and the term "control" is not limited to legal control.

The regulations promulgated under section 7456(b) simply paraphrase the Code section. Sec. 301.7456-1, Proced. & Admin. Regs. Neither our own research nor the written submissions by the parties have disclosed any prior case law under section 7456(b), and there is a paucity of legislative history. The so-called detailed discussion of section 7456(b) in the reports under H.R. 8300 of both the House and Senate

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which the tax treatment of the examined item is an issue shall prohibit the introduction by the taxpayer of any foreign-based documentation covered by such request.

simply parrot the statutory language. See 3 U.S. Code Cong. & Adm. News 4581, 5263, 83d Cong., 2d Sess. (1954). Consequently, we are left on our own to discern the parameters of section 7456(b). Fortunately, the statutory language is straightforward and relatively unambiguous.

In his motion, respondent asks that petitioner be ordered to produce in Court books and records from petitioner's home office in Hong Kong, described in a rider attached to the motion as follows:

> 1. All books, records and documents which were maintained at the petitioner's Head Office with respect to the calculation of petitioner's Gross Income of the Bank From All Sources for the years 1974, 1975 and 1976, including but not limited to the records examined by Peat, Marwick, Mitchell and Co. in preparation of Section I of the *Statement of Certain Items Appearing in the Head Office Records* for the years 1974, 1975 and 1976 attached hereto as Exhibits A, B and C, respectively.
>
> 2. All books, records and documents which were maintained at the petitioner's Head Office with respect to the calculation of Head Office and General Administrative Expenses for the years 1974, 1975 and 1976, including but not limited to the records examined by Peat, Marwick, Mitchell and Co., in preparation of Section II of the *Statement of Certain Items Appearing in the Head Office Records* for the years 1974, 1975 and 1976 attached hereto as Exhibits A, B and C, respectively.
>
> 3. All books, records and documents maintained at the petitioner's Head Office with respect to the calculation of petitioner's total world wide interest expense for the year 1976, including but not limited to the records examined by Peat, Marwick, Mitchell and Co., and/or Price Waterhouse and Co., in preparation of the *Statement of Assets and Interest Paid* attached as Exhibit D.

Respondent argues that the accountant's reports, which petitioner seeks to stipulate, are being offered to prove the truth of the matters contained therein and do not fall within any exception to the hearsay rule contained in rules 803 and 804, Federal Rules of Evidence (FRE). In this connection, FRE rule 803(24) deals with the admissibility of statements having "equivalent circumstantial guarantees of trustworthiness," and FRE rule 804, with the admissibility of certain material in "Declarant Unavailable" situations. At the hearing on the section 7456(b) motion, petitioner cited our opinion in *Karme v. Commissioner*, 73 T.C. 1163, 1180 (1980), affd. 673 F.2d 1062 (9th Cir. 1982), in support of petitioner's position that secondary evidence should be admitted under FRE rules 803(24) and 804(b)(5), in lieu of a section 7456(b) order. We would simply point out that in *Karme*, unlike the case before us, the Commissioner did not seek access to the taxpayer's books and records pursuant to a section 7456(b) order, which, if made, obviates the need for resort to the evidentiary rules.

We need not explore the ramifications of the above-mentioned hearsay exceptions in the context of this case because we believe that a primary purpose of section 7456(b) was to forestall just such an argument as petitioner is making, namely, that secondary sources such as the Peat, Marwick, Mitchell & Co. reports have equivalent circumstantial guarantees of trustworthiness, so taxpayers such as petitioner may thereby be relieved of providing the IRS access to primary sources located abroad.

Respondent also argues that he is entitled to rely upon FRE rule 1002, which requires the production of original documents, and FRE rule 1006, which requires that original voluminous documents shall be made available for examination and copying where summaries are offered in their place. We think that for purposes of this case section 7456(b) also subsumes the thrust of these sections.

In his trial memorandum, respondent makes the following argument in support of the order which he seeks here:

> The computations of petitioner's interest expense deduction for 1976 and its allocated head office expense deductions for 1974, 1975 and 1976 are based on the relationship of petitioner's United States operations to its total world-wide operations. In computing its interest expense deduction for 1976, petitioner calculated the ratio of adjusted U.S. Effectively Connected Assets to its world-wide assets to determine that percentage of its gross world-wide interest expense which is deductible on its United States income tax returns. Similarly, in computing its head office expense deductions petitioner calculated the ratio of U.S. Effectively Connected Gross Income to its world-wide gross income to [determine] that percentage of its total head office administrative expenses which are allocable to its United States income tax returns.
>
> Inspection and verification of each component of the ratios described above are essential to determine the propriety of the deductions claimed on petitioner's income tax returns. The various decisions and judgments made by petitioner and its advisors in arriving at the claimed deductions should be subject to scrutiny by respondent and determination by the Court. For example, the mere fact that a certain expense may be "deductible" as an administrative expense according to the accounting principles applied in Hong Kong does not guarantee that the expense is deductible for federal income tax purposes. However, throughout the audit of this case and continuing during this proceeding, petitioner has refused to permit respon-

> dent to inspect its books and records maintained at its head office in Hong Kong. Thus, respondent has been unable to verify the amounts claimed by petitioner as to the value of its world-wide assets, its total world-wide income, its total world-wide interest expense and its total head office expenses. Rather, petitioner would have respondent and, presumably this Court, rely on the statements of its employees and agents and the workpapers of its auditors.

For the reasons above stated by respondent, we think he has shown "good cause" for some form of order under section 7456(b).

We turn now to the type of order to be granted. We agree with petitioner that it would be wholly impractical for petitioner to produce in Court the books and records specified in the above-quoted rider. Section 7456(b) deals with this kind of contingency, however, by directing the Tax Court to order the foreign entity—petitioner—to make the relevant "books, records, documents, memoranda, correspondence and other papers" (herein called books and records), *wherever situated*, available to the Commissioner for inspection, copying, or photographing. Since the books and records are located in Hong Kong, an appropriate order under section 7456(b) will direct petitioner to make relevant books and records available to respondent in Hong Kong.

We cannot agree that respondent should be forced to speculate, as petitioner seems to be urging, as to what books and records might be material and relevant in this case, based simply upon a perusal of the Peat, Marwick, Mitchell & Co. and Price Waterhouse & Co. reports referred to in the above-quoted rider. As the second circuit noted in *United States v. Arthur Young & Co.*, 677 F.2d 211, 216 (2d Cir. 1982) (in delineating the parameters of an administrative summons under section 7602):

> Before the IRS knows where the issues lie, it has no choice but to utilize a general summons. Similarly, before the Service knows what the documents contain, it cannot describe them with any specificity. If the target's own opinion of relevance controlled, the entire audit process would be eviscerated. * * *

On the other hand, we agree with petitioner that any order fashioned in response to respondent's motion should not mandate to respondent's agents a general rummaging through all of petitioner's books and records, without limitation.

We think the basic criteria for the scope of a section 7456(b) order should be patterned after those for judicial enforcement of an administrative summons set forth in *United States v. Powell*, 379 U.S. 48, 57–58 (1964). Based upon *Powell*, we formulate the following guidelines, namely, (1) that the investigation is to be conducted pursuant to a legitimate purpose, (2) that the inquiry must be relevant to the purpose, (3) that the information sought is not already within the Commissioner's possession, and (4) that the procedural steps required by section 7456(b) have been followed.

First applying the third and fourth of the above criteria to the case before us, we observe that the information sought is not already within the Commissioner's possession because he has yet to see the books and records, and he has complied with the requisite procedural steps by duly filing and serving the motion and notice required by section 7456(b). This leaves the criteria of "legitimate purpose" and "relevant to the purpose" to be dealt with. We agree with respondent that he must be permitted to examine petitioner's books and records in Hong Kong, but legitimacy and relevance require that the scope of the examination be limited to the challenged deductions, namely, the deduction for the indirect general and administrative expenses charged to petitioner's U.S. branches and petitioner's interest expense allocable to its U.S. operations.

At the time of the hearing on respondent's motion, the Court took the testimony of Alfred Ramsey Petrie, Executive Director for the United States of the Hong Kong Bank. Petrie testified that petitioner conducts banking operations in nearly every western country in the world and that less than one-third of its assets are located in the United States. We accept that testimony as truthful. Therefore, notwithstanding the Commissioner's legitimate interest in inspecting petitioner's books and records located in Hong Kong insofar as they relate to petitioner's U.S. operations, we think it would be highly inappropriate for this Court to apply section 7456(b) in a manner which might encourage a tax examination by the Commissioner of petitioner's operations worldwide.

Consideration of principles of international law and comity are undoubtedly involved as a preliminary to the promulgation of any section 7456(b) order. See *Garpeg, Ltd. v. United States*, 583 F. Supp. 789, 794–799 (S.D.N.Y. 1984); see also

United States v. Toyota Motor Corp., 569 F. Supp. 1158, 1162 (C.D. Cal. 1983). But at the hearing on the section 7456(b) motion, respondent's counsel agreed that the scope of the order should be limited to inspection in Hong Kong of books and records relevant to the challenged deductions,[4] and petitioner's counsel stated (contrary to the position taken in petitioner's pre-hearing brief) that the Hong Kong Bank Secrecy Act is not involved here. Without further exploration of the ramifications of that act, we deem this to be a waiver by petitioner of any privilege thereunder. Presumably petitioner is free to take this step because it is petitioner's own affairs, rather than those of a third party (cf. *Garpeg, Ltd. v. United States, supra*), which are under scrutiny here. Thus, the problem of resolving conflicting interests of foreign nations and the United States which vexed the District Courts in *Garpeg* and *Toyota*, is not presented here.

We need not dwell at length on petitioner's remaining objections to a section 7456(b) order. First, we remind petitioner that trials in the Tax Court are de novo, so that the fact that the Commissioner may or may not have changed his theory of the case after sending petitioner a 30-day letter, or that for whatever reason respondent refused to discuss settlement, need not concern us here. See, e.g., *Greenberg's Express v. Commissioner*, 62 T.C. 324, 328 (1974).

Petitioner also alleges that "Congress has now spoken on the subject and has rejected the professed desire of Respondent to conduct worldwide audits of the books and records of foreign corporations," referring to the enactment of section 982 by section 337 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, 96 Stat. 629. Petitioner seems to be saying that Congress, by enacting section 337 of TEFRA, sub silentio repealed section 7456(b).

We reject petitioner's interpretation of the scope of section 982. The Senate report under TEFRA made it clear that section 982 is intended to supplement the Commissioner's administrative summons power to cover those situations where a procedure is necessary to insure timely production of documents held abroad. Conf. Rept. 97–760, to accompany H.R. 4961, 1982–2 C.B. 600, 657–660 (quoting the Senate report). The Conference report added that jurisdiction over a proceeding to quash a summons issued pursuant to section 982 is in the appropriate District Court. Conf. Rept. 97–760, *supra*, 1982–2 C.B. at 659.

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[4] THE COURT: * * * One thing I'm not at all interested in doing is facilitating the Commissioner in making a broad ranging examination of the Bank of Hong Kong and Shanghai's tax affairs. * * *

MR. BORDERS [respondent's counsel]: I completely agree, Your Honor. * * *

Section 7456(b), on the other hand, applies exclusively to the Tax Court, which has no jurisdiction over administrative summons. There is no indication in either section 982, itself, or in its legislative history that section 7456(b) was thereby intended to be superseded, and we so hold.

A final word. Respondent's section 7456(b) motion was filed on August 16, 1985, only 19 days before the trial of this case was scheduled to commence. Under other circumstances, we might have been disposed to deny the motion summarily as being untimely, since any order under the motion would necessarily cause a postponement of the trial. Respondent represents, however, that since the two issues to which the motion relates are essentially questions of substantiation, a lengthy trial on these issues will in all probability be avoided if respondent can be assured through inspection that petitioner's books and records in Hong Kong support the deductions claimed. Petitioner does not strenuously challenge this representation, and we have accordingly entertained the motion. We would observe, nevertheless, that section 7456(b) being substantially analogous to discovery, we would expect the parties in future cases to comply with the time constraints relating to discovery contained in Rule 70(a)(2).

So as to avoid repeating in this opinion the terms and conditions upon which the section 7456(b) order is granted, the provisions of the order are appended as Appendix A. The order reflects terms agreed upon by the parties, as requested by the Court at the conclusion of the hearing on the section 7456(b) motion.

An appropriate order will be entered.

APPENDIX A

UNITED STATES TAX COURT
Washington, D.C. 20217

THE HONGKONG AND SHANGHAI)
BANKING CORPORATION,)
Petitioner,)
v.)
) Docket No. 4075–80
)
COMMISSIONER OF INTERNAL REVENUE,)
)
)
Respondent.)

ORDER

For the reasons expressed in our Opinion filed this date, and served herewith and for good cause appearing of record, it is

ORDERED that Respondent's Motion for an Order under Section 7456(b), I.R.C. 1954, is granted subject to the conditions set forth below. It is further

ORDERED that:

1. Within 45 days from the date of this Order, respondent may visit petitioner's head offices in Hong Kong and commence and within a reasonable time complete an audit of those portions of books, and of the papers, records and documents, located in petitioner's head office in Hong Kong which are relevant to the issues in this case insofar as those portions of books, and those papers, records and documents, are identified in paragraph 2, below.

2. Petitioner shall make available to respondent's auditors the following portions of books, and the following papers, records and documents:

A. Those portions of petitioner's books, and its papers, records and documents, which are relevant to, or were used in, the computation of petitioner's worldwide gross income from all sources for the calendar years 1974, 1975 and 1976. For purposes of identification, the items referred to are the portions of books, and the papers, records and documents, upon which petitioner, and petitioner's chartered accountants and certified public accountants, relied in computing petitioner's "gross income of the bank from all sources" for the years 1974, 1975 and 1976 in the respective amounts of HK $2,629,915,125, HK $2,596,355,570 and HK $2,229,795,986.

B. Those portions of petitioner's books, and its papers, records and documents, which are relevant to, or were used in, the computation of petitioner's head office and general administrative expenses for the calendar years 1974, 1975 and 1976. For purposes of identification, the items referred to are the portions of books, and the papers, records and documents, upon which petitioner, and petitioner's chartered accountants and certified public accountants, relied in computing petitioner's "head office and general administrative expenses" for the years 1974, 1975 and 1976 in the respective amounts of HK $43,934,208, HK $80,588,809 and HK $58,855,364.

C. Those portions of petitioner's books, and its papers, records and documents, which are relevant to, or were used in, the computation of petitioner's total worldwide interest expense for the calendar year 1976. For purposes of identification, the items referred to are the portions of books, and the papers, records and documents, upon which petitioner, and petitioner's chartered accountants and certified public accountants, relied in computing petitioner's "interest paid in 1976" of HK $1,254,498,997.

3. In accordance with the provisions of Section 7456(b), I.R.C. 1954, petitioner shall permit respondent to copy or photograph at respondent's expense any of those portions of its books, and its papers, records and documents, which are within the scope of the inspection permitted by paragraphs 2A., 2B. and 2C., above.

Arthur L. Nims, III
Judge

Dated: Washington, D.C.

LOUISA J. CALDER, PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 28344–82. Filed November 6, 1985.

Upon the facts, *held*:

1. P's transfer to four trusts, involving six beneficiaries, constituted six separate gifts.

2. A blockage discount should be applied to each gift separately in valuing P's gifts, based on the actual annual sales figure for each of the gifts.

3. P's gifts did not create present interests which qualified for exclusion from the gift tax under sec. 2503(b), I.R.C. 1954.

Edward L. Sadowsky and *S. Sidney Mandel*, for the petitioner.

Michael Menillo, for the respondent.

KÖRNER, *Judge*: Respondent determined a Federal gift tax deficiency against Louisa J. Calder (hereinafter petitioner) for the taxable quarter ending December 31, 1976, in the amount of $459,418.60.

The issues for decision are: (1) Whether petitioner's transfers on December 21, 1976, to four trusts, involving six beneficiaries, constituted four or six separate gifts; (2) whether a blockage discount should be applied in valuing petitioner's gifts and, if so, should it be applied to each gift, separately, or applied on an aggregate basis, and in what amounts; and (3) whether petitioner is entitled to a $3,000 exclusion under section 2503,[1] for each of these gifts.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

At the time of filing her petition herein, petitioner was a resident of Roxbury, Connecticut. Petitioner filed a Federal gift tax return for the calendar quarter ending December 31, 1976, with the Internal Revenue Service at Philadelphia, Pennsylvania.

Petitioner is the widow of Alexander Calder, a well-known artist, who died on November 11, 1976. The Estate of Alexander Calder distributed approximately 1,226 gouaches[2] to petitioner. The 1,226 gouaches were included as part of 1,292 gouaches listed by the executors of the Estate of Alexander Calder on its Federal estate tax return filed February 13, 1978. The 1,292 gouaches were reported on the estate tax return as having a fair market value of $949,750, or an average value per gouache of $735. Respondent's appraiser, Karen Carolan, in her valuation report, estimated that the average value per gouache ranged from $2,250 to $2,500, resulting in a total value ranging from $2,907,000 to $3,230,000 for the 1,292 gouaches in the estate. She further determined that because of the large number of gouaches, a "blockage" discount of about 60 percent was in order. This resulted in a net fair value ranging from $1,164,600 to $1,293,800. Respondent concluded that the $949,750 claimed on the estate tax return was within an acceptable range and no change was recommended.

On December 21, 1976, petitioner created four irrevocable trusts, one each for the benefit of her daughters, Sandra Calder Davidson (the Davidson Trust) and Mary Calder Rower

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

[2] As used in this opinion the term "gouache" refers to a form of original painting executed with opaque water colors. See The Random House College Dictionary (rev. ed. 1982).

(the Rower Trust), one for the benefit of her grandchildren, Shawn and Andrea Davidson (the Davidson Children Trust), and one for the benefit of her other grandchildren, Alexander and Holton Rower (the Rower Children Trust). The two trust indentures creating the Davidson and the Rower Trusts were identical except for the designation of the person who was to constitute the beneficiary of each trust. The relevant provisions of one of the trust indentures are as follows:

> THIS INDENTURE or DEED OF TRUST, made this 21st day of December, 1976, BY and BETWEEN LOUISA J. CALDER, residing at Sache 27190, Republic of France, party of the first part (hereinafter referred to as the Grantor) and ROBERT S. FRIEDMAN, of 261 Madison Avenue, New York, New York and STANLEY COHEN, of 44 Avenue des Champs-Elysees 75008 Paris, France, parties of the second part (hereinafter referred to as the Trustees), WITNESSETH:
>
> * * * * * * *
>
> FIRST: A. The Trustees shall hold, invest and reinvest the Trust Estate for and during the lifetime of the Grantor's daughter, SANDRA CALDER DAVIDSON, and shall collect and receive the interest, dividends, issues and income of the Trust Estate and after paying therefrom all necessary and property [sic] charges and expenses, the Trustees shall pay over the net income to the Grantor's daughter, SANDRA CALDER DAVIDSON, in periodic installments for and during the term of her natural life.

The two trust indentures creating the Davidson Children and the Rower Children Trusts were identical except for the designation of the persons who were to constitute the beneficiaries of each trust. The relevant provisions of one of the trust indentures are as follows:

> THIS INDENTURE or DEED OF TRUST, made this 21st day of December, 1976 BY and BETWEEN LOUISA J. CALDER, residing in Sache 37190, Republic of France, party of the first part (hereinafter referred to as the Grantor) and ROBERT S. FRIEDMAN, of 261 Madison Avenue, New York, New York and STANLEY COHEN, 44 Avenue des Champs-Elysees 75008 Paris, France, parties of the second part (hereinafter referred to as the Trustees), WITNESSETH:
>
> * * * * * * *
>
> FIRST: A. The Trustees shall divide the Trust Estate into two equal parts, and shall hold, invest and reinvest such parts as separate trust funds, subject to the terms hereof, for the respective lifetimes of SHAWN DAVIDSON and ANDREA DAVIDSON (the "beneficiaries") and shall collect and receive the

interest, dividends, issues and income of the Trust Estate and after paying therefrom all necessary and proper charges and expenses, the Trustees shall pay over the net income in equal shares to the beneficiaries or to their issue, as hereinafter provided, in periodic installments for and during the term of their respective lives.

The relevant provisions common to all four trusts are as follows:

> Anything hereinabove contained to the contrary notwithstanding the trustees, in the exercise of their absolute and uncontrolled discretion, may at one time or from time to time pay over to either of the beneficiaries from the principal of the Trust Estate such a sum or sums, even to the extent of the whole thereof, as the Trustees may deem advisable for the welfare of the beneficiaries, and upon making any such payment or payments the Trustees shall be discharged from all further liability, responsibility or accountability with respect thereto.
>
> * * * * * * *
>
> FIFTH: The Trustees shall have the following express powers exercisable in their sole and absolute discretion with respect to all property whether principal or income at any time coming into their hands, whether by purchase or in any other manner, and every power of the trustees shall continue with respect to any such property until the execution of every trust and every power in trust with respect thereto shall have been completed by the actual and final distribution thereof under the terms of this agreement.
>
> A. To hold and continue to hold as an investment the property received hereunder, and any additional property which may be received by them, so long as they deem proper, whether or not income producing, deemed by them to be for the best interests of the trust and the beneficiaries hereunder, without being limited to trust or chancery investments provided by law, and notwithstanding that the same may constitute leaseholds, royalty interest [sic], patents, interests in mines, oil and gas wells, or timber lands, or other wasting assets, and without any responsibility for any depreciation or loss by or on account of such investments.
>
> * * * * * * *
>
> C. To sell and convey any of the property of the trust or any interest therein, or to exchange the same for other property, whether or not such other property is income producing, for such price or prices and upon such terms as in their discretion and judgment may be deemed for the best interest of the trust and the beneficiaries hereunder, and to execute and deliver any deed or deeds (with or without warranty), receipts, releases, contracts or other instruments necessary in connection therewith.
>
> * * * * * * *

NINTH: The Grantor hereby declares that this agreement and all trusts and beneficial interests, whether vested or contingent, hereby created, shall be irrevocable and that the Grantor shall hereafter stand without power at any time to revoke, change or annul any of the provisions herein contained or any of the contingent or beneficial interests effected thereby, whether pursuant to a statute of the State of New York or decisions of its courts or otherwise.

TENTH: This agreement shall be governed by the laws of the State of New York and shall become effective upon its being executed by the Grantor and one Trustee. * * *

On the same day the trusts were created, December 21, 1976, petitioner executed the following transfers:

TABLE 1

Trust title	*Beneficiaries*	*Number of gouaches transferred*	*Reported fair market value on Schedule A of petitioner's gift tax return*
Davidson Trust	Petitioner's daughter Sandra Calder Davidson	306	$237,437.50
Davidson Children Trust	Petitioner's grandchildren Shawn and Adrea Davidson	307	237,437.50
Rower Trust	Petitioner's daughter Mary Calder Rower	306	237,437.50
Rower Children Trust	Petitioner's grandchildren Alexander and Holton Rower	307	237,437.50
	Total	1,226	949,750.00

The parties have stipulated that the average retail value per gouache was $2,375 and that the value of the individual gouaches did not vary between the date of Alexander Calder's death, November 11, 1976, and the date of petitioner's gift, December 21, 1976. As table 1 indicates, petitioner reported the total value of the gifts on her gift tax return to be $949,750.[3] Petitioner estimated that because the fair market value of the gouaches did not vary between the date of the death and the date of the gift, the same blockage discount of 60 percent that was used for the estate tax return should be used for the gift tax return. Accordingly, the gouaches were claimed to have the same value for both gift and estate tax return purposes.

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[3] Petitioner, in Schedule A of the gift tax return erroneously listed the 1,226 gouaches transferred to the four trusts as having an aggregate fair market value of $949,750, the same aggregate fair market value as reported for the 1,292 gouaches on the estate tax return, when in fact only the 1,226 gouaches were transferred.

Respondent, however, calculated that for gift tax purposes the blockage discount should be based on six separate transfers,[4] with the impact on the market of each transfer being considered independently. The blockage discount was calculated by respondent for each transfer as follows:

TABLE 2

Transfer number	*Number of gouaches in each transfer*	÷	*Estimated average number of gouaches sold per year*[5]	=	*Estimated approximate number of years required to sell off block*
1 (Davidson)	306		61		5
2 (Rower)	306		61		5
3 (Davidson child)	154		51		3
4 (Davidson child)	153		51		3
5 (Rower child)	153		51		3
6 (Rower child)	154		51		3
Total	1,226				

Transfer number	*Present value factor at 10 percent*[6] *for annuities*	×	*Estimated average number of gouaches sold per year*	×	*Agreed average price per gouache*	=	*Determined value*
1	3.79078		61		$2,375		$550,000
2	3.79078		61		2,375		550,000
3	2.4868		51		2,375		300,000
4	2.4868		51		2,375		300,000
5	2.4868		51		2,375		300,000
6	2.4868		51		2,375		300,000
Rounded total value of the transfers							2,300,000

The net result or effect of respondent's approach was to grant petitioner a blockage discount of 25 percent with respect to transfers 1 and 2, and a discount of 18 percent with respect to transfers 3 through 6.[7]

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[4] Respondent treated the transfers made to each beneficiary as separate gifts.

[5] This annual liquidation rate is not revealed in respondent's evidence, but is derived mathematically from his other computations.

[6] Sec. 25.2512–9, Gift Tax Regs., indicates that for transfers made after Dec. 31, 1970, and before Dec. 31, 1983 (as is the case here), the present value factor is based on a 6-percent factor. If applied here this would result in a higher capitalization factor and consequently a higher value for gift tax purposes. Respondent has inexplicably applied a 10-percent discount rate (the effective rate for transfers made after Nov. 30, 1983. Sec. 25.2512–5). Neither party contests this treatment.

[7] Thus: As to transfers 1 and 2:

306 gouaches × $2,375 (agreed retail value) = $726,750 (total retail value)
$550,000 (determined value) ÷ $726,750 = 0.75

As to transfers 3 through 6:

153/154 gouaches × $2,375 = $365,750
$300,000 (determined value) ÷ 365,750 = 0.82

Respondent accordingly determined a deficiency of gift tax based, inter alia, upon the difference between the $949,750 value reported by petitioner and the $2,300,000 value determined by him.

Respondent calculated the figure for the estimated average number of gouaches sold per year for the estate tax return using an estimated liquidation period of 25 years for the total number of gouaches in the estate (1,296), resulting in approximately 50 sales per year for the *entire* estate (1,296 ÷ 25 = 51.84). In calculating the appropriate valuation for purposes of the instant gift tax case, respondent built upon his prior valuation of the gouaches for estate tax purposes, viz, that the marketplace would absorb about 50 of these art works each year. In the case of the transfers in trust of 153/154 gouaches to the Davidson children and the Rower children (transfers 3 through 6), respondent used approximately the same liquidation rate (51 per year) for *each* gift that he had assumed for estate tax purposes for the *entire* estate. For the transfers to the Davidson Trust and the Rower Trust (transfers 1 and 2), however, respondent assumed a liquidation of 61 gouaches per year for each of the gifts.

Apparently from the date of the gift until March 31, 1978, the exclusive representative for the sale of the gouaches was the Perls Gallery of New York City. Beginning April 1, 1978, and continuing until April 1, 1984, the exclusive representative was M. Knoedler & Co., Inc., of New York City. Thereafter, and continuing for a period of 5 years, the exclusive representative was the Pace Gallery of New York City.

The number of gouaches which were actually sold during the years 1977 through 1984 is as follows:

TABLE 3

NUMBER OF GOUACHES SOLD

Year ended	*Davidson Trust*	*Davidson Children Trust*	*Rower Trust*	*Rower Children Trust*	*Total*
10/77	16	14	16	6	52
10/78	20	12	18	20	70
10/79	34	31	31	25	121
10/80	14	6	10	15	45
10/81	9	14	12	17	52

TABLE 3
(cont'd)
NUMBER OF GOUACHES SOLD

Year ended	*Davidson Trust*	*Davidson Children Trust*	*Rower Trust*	*Rower Children Trust*	*Total*
10/82	7	6	3	4	20
10/83	3	4	1	- - -	8
10/84	- - -	1	- - -	- - -	1
Total	103	88	91	87	369
Average number sold per year during the years 1977–1984	13	11	11	11	46
Average number sold per year during the years 1977–1982	17	14	15	14	60

On her gift tax return, petitioner claimed the annual donee exclusion pursuant to section 2503 of $3,000 for each income beneficiary of each of the four trusts, viz, six persons, for an aggregate of $18,000 of total annual donee exclusions. Respondent determined that such exclusions were not allowable.

OPINION

The first issue for decision is whether petitioner's transfers on December 21, 1976, to the four trusts, involving six beneficiaries, constituted four or six separate gifts.

In the present case, there were four transfers made to four trusts. Two of these trusts, the Davidson Trust and the Rower Trust, each had one beneficiary, while the remaining two trusts, the Davidson Children Trust and the Rower Children Trust, each had two beneficiaries.

Petitioner apparently contends that because four transfers were made to four trusts, only four gifts were made, despite the fact that there were six beneficiaries.[8]

Respondent's position that six gifts are presented for valuation purposes is well fortified both in the law and in the provisions of the trust instruments, themselves. It is well settled that gifts in trust are to be regarded for gift tax purposes as gifts to the beneficiaries rather than to the trustees. *Helvering v. Hutchings*, 312 U.S. 393, 396 (1941); *United States v. Pelzer*, 312 U.S. 399, 401–402 (1941); *Jones v. Commissioner*, 29 T.C. 200, 210 (1957); *Avery v. Commissioner*, 3 T.C. 963, 970 (1944). The Davidson Children Trust and the Rower Children Trust both provide "The Trustees shall divide the Trust Estate into two equal parts, and shall hold, invest and reinvest such parts as separate trust funds" and "the Trustees shall pay over the net income in equal shares to the beneficiaries."

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[8] Petitioner inconsistently claims, however, that for purposes of the annual exclusion under sec. 2503, six gifts were made. See discussion *infra*.

It follows that for purposes of the gift tax and for purposes of valuation, there were six separate gifts. The two gifts to the Davidson Trust and to the Rower Trust each consisted of 306 gouaches. For calculation purposes, the four gifts to the Davidson Children Trust and to the Rower Children Trust should be divided into four approximately equal portions, two gifts consisting of 154 gouaches and two gifts consisting of 153 gouaches. Respondent properly did this.

The second issue for decision is whether a blockage discount[9] should be applied in valuing petitioner's gifts, and if so, should it be applied to each gift separately or applied on an aggregate basis, and in what amounts.

It is noteworthy that the parties agree that the average retail[10] value per gouache was $2,375. Thus, this is not a strict valuation case per se, but rather the controversy centers on the appropriate blockage discount, if any, to be applied.

Respondent initially contends that it is inappropriate to apply the blockage discount in the gift tax area. The discount is appropriate in the estate tax area since the estate may have difficulty disposing of a large block of inventory; on the other hand, in the gift tax area, contends respondent, the discount is inappropriate because gifts, unlike deaths, are contemplated events and one can manipulate the circumstances surrounding the transfers. However the regulations and the case law are squarely to the contrary. Sec. 25.2512–2(e), Gift Tax Regs.;

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[9] The blockage rule provides that when a commodity is being valued, the size of the block being valued, and not simply the value determined for each item, is a relevant consideration. See *Rushton v. Commissioner*, 498 F.2d 88, 90, rehearing denied 502 F.2d 1167 (5th Cir. 1974), affg. 60 T.C. 272 (1973).

[10] Sec. 25.2512-2, Gift Tax Regs., indicates that the value to be used for gift tax purposes is the price at which the item would be sold at retail.

Rushton v. Commissioner, 498 F.2d 88, rehearing denied 502 F.2d 1167 (5th Cir. 1974), affg. 60 T.C. 272 (1973); *Whittemore v. Fitzpatrick*, 127 F. Supp. 710 (D. Conn. 1954). As such, we feel that the blockage discount may be applied to gifts.

Petitioner argues that a discount should be applied to the 1,226 gouaches on an aggregate basis in order to take into account the time necessary for an orderly liquidation. Respondent, on the other hand, contends that the blockage discount must be applied to each gift separately. In support of this proposition respondent cites section 25.2512–2(e), Gift Tax Regs.; *Rushton v. Commissioner, supra*; and *Whittemore v. Fitzpatrick, supra*.

Section 25.2512–2(e), Gift Tax Regs., states in pertinent part that:

> If the donor can show that the block of stock to be valued, *with reference to each separate gift*, is so large in relation to the actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market, the price at which the block could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. * * * [Emphasis added.]

Petitioner contends that the principles set forth in this regulation apply only when valuing stocks and bonds and are not applicable when valuing works of art. Under petitioner's approach we would value the gouaches under the more general guidelines appearing in section 25.2512–1, Gift Tax Regs., which provides in part that:

> The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts. * * *

The relevant facts petitioner would have us examine are the ability of an art dealer to control the market in terms of determining how many gouaches would be available for sale at any one time, and the length of time necessary to liquidate the art work. These same factors are relevant in determining the amount of the blockage discount. In fact, in determining the appropriate blockage discount for both estate and gift tax purposes, the length of time necessary to liquidate the gouache holdings was a primary factor used by both parties in coming up with their results.

Thus, in effect, petitioner urges us to apply the same factors used in estimating the blockage discount without being bound by the regulation which authorizes its use. With this we cannot agree. If petitioner desires the benefits of the blockage discount, she must also be willing to accept its limitations. Accordingly, the blockage discount must be applied with reference to each separate gift.

We are not without authority in this area. In *Rushton v. Commissioner, supra*, the Fifth Circuit was requested to value 16 gifts of unlisted common stock. The court held that section 25.2512–2(e), Gift Tax Regs., required it to apply the blockage discount to each gift separately without considering companion donations. It reasoned:

> An aggregation principle, however, directly contradicts the regulatory intent of appraisal in a realistic market; for under such a system the question becomes not what would each block have returned if sold in the market existing at the time of valuation, but rather what would the same block have brought in a fictitious market, one flooded by the other gifts.[11] [498 F.2d at 93.]

The blockage discount has also been applied to separate rather than to consolidated gifts in the area of closely held stock. *Whittemore v. Fitzpatrick, supra*. Thus, it hardly seems a quantum leap to extend these principles to the valuation of art work, particularly because, as petitioner admits on brief, liquidating a block of closely held securities is analogous to liquidating a block of 1,226 gouaches. In both cases, there is no established market in which to make a disposition, and both involve sales which are privately negotiated between the buyer and the seller. We therefore conclude that a blockage discount must be determined separately for each of the six gifts.

Having decided that separate discount rates are required, we must now determine the appropriate discount rates for each gift. It is here that we part company with respondent.

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[11] Petitioner apparently contends that *Rushton* is distinguishable because there, four blocks of stock were gifted over the course of 15 months, unlike here, where all of the gifts were made simultaneously. This is not a relevant distinction because in *Rushton*, the court concluded that even gifts made on the same day could not be aggregated for purposes of determining the blockage discount. 498 F.2d at 91–95.

Respondent calculated the blockage discount by estimating the number of gouaches to be sold per year for each of the six gifts. (See table 2, p. 718.) Then, using this figure, respondent computed the number of years it would take to liquidate each block. This next figure was then used as a basis for determining the appropriate annuity factor to be applied in calculating the discount. Thus, respondent treated the gouaches here as a large number of illiquid assets, whose worth could be realized only through liquidation over a period of time at a uniform rate, yielding an assumed amount of dollars each year over such period. Under this approach, realization of the value of the art works can be compared to the right to receive an annuity of the stated amount over the given period, and the present worth of such annuity can be determined from the appropriate valuation tables. Sec. 25.2512-5, Gift Tax Regs. The appropriate valuation factor reflects a discount for the amount of time the various installments of the annuity are deferred. As applied in the instant case, the effect is to grant a blockage discount in a somewhat more sophisticated manner than the usual method of applying a single percentage discount to the retail value of the items at the date of the gift. We are not prepared to say that respondent's theory is unreasonable, but its accuracy obviously depends upon the validity of respondent's assumptions regarding the number of gouaches that can be liquidated each year and, thus, the length of time such liquidation will require.

As table 2 indicates, respondent calculated the selloff period for the blocks of 306 gouaches using estimated sales of 61 gouaches per year. The blocks of 154 and 153 gouaches were computed to be sold at a rate of 51 per year. The problem with respondent's method is that it yields a total annual sales figure for all six blocks of approximately 330. This simply does not comport with reality, as revealed by this record. The record shows that the average sales figure for all four trusts (i.e., all six blocks) during the years 1977 through 1982 was 60 per year.[12] (See table 3, pp. 719–720.) We agree that the discount should be calculated for each gift separately, but it is not realistic to apply the total sales figures for *all* gouaches sold during the year to *each* gift, separately, in determining the liquidation period. Rather, it seems more logical to us to use the actual average annual sales for *each* of the six gifts to determine the relative liquidation periods. There is no evidence that any of the trusts withheld gouaches from the market during the period 1977–82. To the contrary, they were placed with an art gallery in New York City and were all for sale.

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[12] Sales of art work before and after the date of the gift may be used to corroborate the ultimate determination of value provided they are not too far removed from such date. *Estate of Smith v. Commissioner*, 57 T.C. 650, 659 n. 8 (1972), affd. on other grounds 510 F.2d 479 (2d Cir. 1975), cert. denied 423 U.S. 827 (1975). We realize that *Estate of Smith* is an estate tax case, however, the provisions relating to value in the gift and estate tax areas have been held to be in pari materia. *Merrill v. Fahs*, 324 U.S. 308, 311–313 (1945). The average annual sales figure was calculated by

While respondent contends that *Rushton v. Commissioner, supra*, requires us to look to what the market would absorb (here 60 gouaches per year) and apply this figure to each gift, separately, to determine the liquidation period, we believe that because blockage is a question of fact rather than a rule of law (*Estate of Sawade v. Commissioner*, T.C. Memo. 1984–626; *Estate of Christie v. Commissioner*, T.C. Memo. 1974–95; see *Safe Deposit & Trust Co. of Baltimore v. Commissioner*, 35 B.T.A. 259 (1937), affd. 95 F.2d 806 (4th Cir. 1938)), the actual sales experience in the period is the best evidence we have of the true absorption rate of the gouaches in the marketplace, and should be preferred to determine the estimated liquidation period for the purposes of determining the appropriate amount of blockage through an annuity approach. Moreover, in *Rushton*, the court was concerned that an aggregation principle would require it to create a fictitious market, one flooded by the other gifts to determine the appropriate discount. Here, however, as we have stated, it is unnecessary to create any market fictions because we have access to the actual sales figures.

It is for these reasons that we feel that the following table, which uses the actual average annual sales figure for each of the six gifts, provides a better estimate of the blockage discount rates to be applied in determining the value of the gifts:

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respondent without including the sales of 1983 and 1984. Respondent contends that these years were not representative because during this time the trustees entered a contract with a different gallery which did not make the same effort to market the gouaches as the previous gallery had. Petitioner has offered no evidence on this point. Without deciding the validity of respondent's contention we feel the sales for 1983 and 1984, which were substantially lower than those during the prior 6-year period, are not representative because they are too far removed from the date of the gift, Dec. 21, 1977.

TABLE 4

Gift number	Number of gouaches in each gift ÷	Average number of gouaches sold per year[13] =	Appropriate number of years required to sell off block
1	306	17	18
2	306	15	20
3	154	7	22
4	153	7	22
5	153	7	22
6	154	7	22

Gift number	Present value factor at 10 percent for annuities ×	Average number of gouaches sold per year ×	Average price per gouache =	Value
1	8.2014	17	$2,375	$330,000
2	8.5136	15	2,375	300,000
3	8.7715	7	2,375	145,000
4	8.7715	7	2,375	145,000
5	8.7715	7	2,375	145,000
6	8.7715	7	2,375	145,000
Total value of the gifts				1,210,000

Accordingly, we conclude that the appropriate value of the property for gift tax purposes is $1,210,000, which includes an appropriate discount for blockage.

The third issue for decision is whether petitioner is entitled to six $3,000 annual exclusions under section 2503, in computing taxable gifts for transfers of the gouaches to the four trusts.

Section 2503(b), as in effect at the time of transfer,[14] provided for the exclusion of the first $3,000 of gifts to any person[15] during a calendar year. The exclusion, however, is only available to gifts "other than gifts of future interests in property," or in other words to present interests. Accordingly, the determination of this issue requires the inquiry whether, at the date of each gift, the interest received by a beneficiary was a present or future interest. *Blasdel v. Commissioner*, 58 T.C. 1014, 1017 (1972), affd. per curiam 478 F.2d 266 (5th Cir. 1973). For gift tax purposes the term "present interest in property" is defined as "An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain)." Sec. 25.2503–3(b), Gift Tax Regs. The term "future interest in property" refers to "any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date." H. Rept. 708, 72d Cong., 1st Sess. (1932), 1939–1 C.B. (Part 2) 478; S. Rept. 665, 72d Cong., 1st Sess. (1932), 1939–1 C.B. (Part 2) 526. See also *Commissioner v. Disston*, 325 U.S. 442, 446 (1945), revg. 144 F.2d 115 (3d Cir. 1944), revg. a Memorandum Opinion of this Court; sec. 25.2503–3(a), Gift Tax Regs. The Supreme Court in *Fondren v. Commissioner*, 324 U.S. 18, 20 (1945), refined these definitions by indicating that the donor is entitled to the exclusion only if he has conferred on the donee "the right to substantial present economic benefit."

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[13] These figures are taken from table 3, with slight variations to account for the fact that six rather than four gifts were made.

[14] As it read in 1976, sec. 2503(b) provided:

SEC. 2503(b). EXCLUSIONS FROM GIFTS.—In computing taxable gifts for the calendar quarter, in the case of gifts (other than gifts of future interests in property) made to any person by the donor during the calendar year 1971 and subsequent calendar years, $3,000 of such gifts to such person less the aggregate of the amounts of such gifts to such person during all preceding calendar quarters of the calendar year shall not, for purposes of subsection (a), be included in the total amount of gifts made during such quarter. Where there has been a transfer to any person of a present interest in property, the possibility that such interest may be diminished by the exercise of a power shall be disregarded in applying this subsection, if no part of such interest will at any time pass to any other person.

These principles are exemplified in *Commissioner v. Disston, supra*, where the Supreme Court concluded that a future interest was created when the trust had income but limitations were placed on its disbursement. In that context the Court explained:

> In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the [beneficiary] would be required, there is no basis for a conclusion that there is a gift of anything other than for the future. The taxpayer claiming the exclusion must assume the burden of showing that the value of what he claims is other than a future interest. * * * [325 U.S. at 449.]

Disston thus requires the taxpayer to prove three things: (1) That the trust will receive income, (2) that some portion of that income will flow steadily to the beneficiary, and (3) that the portion of income flowing out to the beneficiary can be ascertained. See also *Maryland National Bank v. United States*, 609 F.2d 1078, 1080 (4th Cir. 1979).

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[15] In the case of gifts made in trust, the beneficiary, not the trust or trustee, is the "person" to whom the statute refers. *Helvering v. Hutchings*, 312 U.S. 393, 396 (1941).

Application of these principles to the facts of this case does not present a problem. Petitioner has failed to meet even the first prong of the *Disston* test. At the date of transfer, although the beneficiaries had the right to periodic distributions of income, the corpora of the trusts in question merely consisted of the gouaches. There has been no showing that the trust assets will generate income for distribution to the beneficiaries. Petitioner has not, for example, shown that the gouaches will generate rental income or, for that matter, any other type of income. In *Maryland National Bank v. United States, supra*, the Fourth Circuit was faced with determining whether the gift of an unqualified right to receive profits from the operation of a partnership's business was a present interest. In holding that a future interest was created, the court stated "The executor has failed to prove that the partnership has produced any income for distribution to the beneficiaries, that steps have been taken to eliminate the losses it has sustained annually, or that there will be any income in the foreseeable future." 609 F.2d at 1080.[16] Similarly, here the record does not establish that the beneficiaries will actually receive a steady flow of income or any income whatsoever.[17]

Petitioner, on the other hand, contends that a present interest exists because the trustees have the discretionary power under the terms of the trusts to convert non-income-producing assets (i.e., the gouaches) into income-producing property. Moreover, petitioner argues that pursuant to the State law governing the terms of the trusts, a fiduciary duty is imposed on the trustees to liquidate the gouaches and convert them into income-producing property. In support of this proposition petitioner cites *Rosen v. Commissioner*, 397 F.2d 245 (4th Cir. 1968), revg. 48 T.C. 384 (1967). In *Rosen*, the Fourth Circuit held that the donee exclusion was allowable, relying partially on the fact that the trustees had the power to sell non-income-producing assets (i.e., stock which had no dividend history) and to reinvest the proceeds in income-producing property.

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[16] Petitioner contends that *Maryland National Bank v. United States*, 609 F.2d 1078, 1080 (4th Cir. 1979), is distinguishable from the present case because there, unlike here, the trustees were prohibited from converting the non-income-producing assets into income-producing assets. The court in *Maryland National Bank* relied on two points in reaching its conclusion: that neither the circumstances of the case *nor* the provisions of the trust established that the beneficiaries received a steady flow of income. Here we are only concerned with whether the circumstances of the case provide a basis for determining that the beneficiaries would receive a steady flow of income. The provisions of the trust will be examined *infra*.

[17] Nor can it be said that at the date of gift a right to a "substantial present economic interest" was conferred on the donees. Although petitioner could contend that the beneficiaries have received a substantial present economic interest in that they have apparently received the proceeds from the sales of the gouaches (though this is far from made clear in the record), the distribution of the proceeds (i.e., trust corpus) is at the discretion of the trustees, and thus, not a *right* of the beneficiaries. It is well settled that where, as in the instant case, there is a gift of income coupled with a power in the trustee to encroach upon principal at such times and in such amounts as it deems proper, the interest of the beneficiaries in such possible advancement is a future interest. *Jones v. Commissioner*, 29 T.C. 200, 210 (1957); *Fondren v. Commissioner*, 324 U.S. 18, affg. 141 F.2d 419 (5th Cir. 1944), affg. 1 T.C. 1036 (1943); *Commissioner v. Disston*, 325 U.S. 442, 446, 447 (1945), revg. 144 F.2d 115 (3d Cir. 1944), revg. a Memorandum Opinion of this Court; *Kniep v. Commissioner*, 172 F.2d 755, 756 (8th Cir. 1949), affg. 9 T.C. 943 (1947).

Rosen is inapposite to the facts herein for several reasons. First, *Rosen* was actually addressing the third prong of the *Disston* test, that is, whether the income interest was subject to valuation. There the Government had conceded that "a valuable right to receive income has been donated" (379 F.2d at 248), and that "a *present* income interest * * * was in fact donated." 397 F.2d at 245 (emphasis in original). Here no such concessions have been made. Second, in *Berzon v. Commissioner*, 63 T.C. 601 (1975), affd. 534 F.2d 528 (2d Cir. 1976), we refused to follow *Rosen*. There we disagreed with the Fourth Circuit's reliance in *Rosen* on the power of the trustees to sell gifted shares and reinvest the proceeds in income-producing property where there was no direction in the trust indenture or inclination shown by the trustees to do so. We stated, "In such cases the possibility itself that the trustees would sell the gifted stock and reinvest in income-producing property is so uncertain as to be incapable of being valued." 63 T.C. at 618–619. Thus, even assuming, arguendo, that a present interest was created, it is not capable of valuation because it is impossible to predict with certainty whether and to what extent the trustees would sell the gouaches and invest in income-producing property. This proposition is further supported by the Second Circuit[18] which, in affirming *Berzon*, stated "the [actuarial] tables are not appropriate in the case of a *non*-income yielding investment, for in such a case one can predict with assurance that the income generated will be *zero* and, therefore, that the actuarial tables would produce an obviously erroneous result." 534 F.2d at 532 (emphasis in original).[19] Accord *Stark v. United States*, 477 F.2d 131 (8th Cir. 1973); *Fischer v. Commissioner*, 288 F.2d 574 (3d Cir. 1961), affg. a Memorandum Opinion of this Court.

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[18] In the instant case, any appeal lies to the Court of Appeals for the Second Circuit and thus we must consider that court's interpretation of the law in this area. *Golsen v. Commissioner*, 54 T.C. 742, 756–757 (1970), affd. 445 F.2d 985 (10th Cir. 1971), cert. denied 404 U.S. 940 (1971). As indicated in the text, *Berzon v. Commissioner*, 63 T.C. 601 (1975), affd. 534 F.2d 528 (2d Cir. 1976), was affirmed by the Second Circuit and thus we feel compelled to apply the *Berzon* reasoning, rather than using that of the court in *Rosen v. Commissioner*, 397 F.2d 245 (4th Cir. 1968), revg. 48

Finally, although the trust indentures in the present case authorize the trustees to sell the gouaches and reinvest the proceeds in income-producing property (as well as non-income-producing property), there is no indication in the record that they intended to reinvest in such a manner. In fact, the record merely indicates that when a gouache was sold a check was issued to the trustee. No mention is made as to whether the proceeds were actually invested in any type of property.

In sum, neither the circumstances of the case nor the provisions of the trust indentures realistically establish that the beneficiaries will receive a steady flow of income. We therefore conclude that petitioner's gifts did not create a present interest that qualified for exclusion from the gift tax.

To reflect the foregoing,

Decision will be entered under Rule 155.

T.C. 384 (1967). Moreover, the Fourth Circuit seems to have backed down from the stance originally taken in *Rosen*. See *Maryland National Bank v. United States*, *supra* at 1081–1083.

[19] Petitioner contends that *Berzon* is distinguishable from *Rosen* because in *Berzon*, unlike *Rosen*, there was a shareholders' agreement restricting the transfer of the stock and because the trustee manifested no intention to generate income from its investments. Without deciding the validity of these distinctions, we feel that *Rosen* is not applicable to the facts here because of the reasons enumerated in the text.

EDWARD VANICEK, DECEASED, AND SARA VANICEK, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

JOHN B. MODEN AND RUTH MODEN, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 16187-79, 16201-79. Filed November 6, 1985.

During the years in issue, Ps were employed as resident watchmen by the Forest Preserve District of Cook County, Illinois, to safeguard certain areas of land owned by the district. As a condition of their employment, Ps were required to occupy lodgings strategically located within their assigned areas. The district allowed Ps to live in the lodgings rent free. *Held*, Ps are entitled to exclude the value of the lodgings from income under sec. 119, I.R.C. 1954. *Benninghoff v. Commissioner*, 71 T.C. 216 (1978), affd. per curiam 614 F.2d 398 (5th Cir. 1980), distinguished. *Held, further*, Ps are not entitled to deduct under sec. 162 certain expenses incurred operating and maintaining the lodgings.

J. Patrick Doherty and *Robert A. Bedore*, for the petitioners.
William C. Sabin, Jr., for the respondent.

NIMS, *Judge*: In these consolidated cases, respondent determined the following deficiencies in petitioners' Federal income taxes:

Docket No.	*Petitioner*	*Year*	*Deficiency*
16187-79	Edward Vanicek, deceased, and Sara Vanicek	1972	$1,636.04
		1973	2,781.76
		1974	3,626.76
16201-79	John B. Moden and Ruth Moden	1972	829.20
		1973	895.25
		1974	957.00

The issues for decision are (1) whether the fair rental value of lodging furnished to petitioners by their employer, the Forest Preserve District of Cook County, Illinois, is excludable from gross income under section 119[1]; and (2) whether the Vaniceks are entitled to deduct under section 162 certain expenses incurred operating and maintaining their residences.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 in effect for the years in question. All Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference.

Petitioners Edward Vanicek and Sara Vanicek, husband and wife, resided in Ironton, Missouri, when they filed the petition in this case. Petitioners John B. Moden and Ruth Moden, husband and wife, resided in San Diego, California, when they filed the petition in this case. The parties have stipulated pursuant to section 7482(b)(2) that the decision of the Court in these cases may be reviewed by the U.S. Court of Appeals for the Seventh Circuit.

The Forest Preserve District

During the years in issue, petitioners Edward Vanicek and John Moden were employed by the Forest Preserve District of Cook County, Illinois (hereinafter sometimes referred to as the district). The district, an incorporated political unit of the State of Illinois, was created by State statute in 1915 "To acquire * * * and hold lands * * * containing one or more natural forests or lands connecting such forests or parts thereof, for the purpose of protecting and preserving the flora, fauna and scenic beauties within such district, and to restore, restock, protect and preserve the natural forests and said lands together with their flora and fauna, as nearly as may be, in their natural state and condition, for the purpose of the education, pleasure, and recreation of the public."

Since 1915, the district has systematically acquired property to return the land to its natural state as well as to develop golf courses, swimming pools, nature centers, and picnic areas on and throughout the district property. This systematic reconstruction and preservation is intended to benefit the people of the entire Chicago metropolitan area. As of February 19, 1975, the district owned 64,730 acres of land throughout Cook County, Illinois.

The general headquarters for the district is located in the approximate center of its land holdings. Twelve division headquarters are located throughout the district property. The division headquarters are operated by law enforcement officers, called "rangers," who are responsible for the safe operation of the district lands. The rangers are on duty at the division headquarters from 9 a.m. until 1 a.m. In the event an emergency occurs while the rangers are not on duty, individuals on duty at the general headquarters attempt to call rangers at home, the local police, or resident watchmen.

Resident watchmen are selected from employees of the district by the district's general superintendent to protect designated areas within the district from fire, hunting, vandalism, or other encroachment. The district initiated the resident watchman program in 1918 to support the rangers in the performance of their duties. Although the services performed by the resident watchmen were often duplicative of the services performed by the rangers, this duplication was necessary, given the inadequate number of rangers available to patrol all of the district's land.

As a condition of being a resident watchman, people performing this function were required to live in residences strategically located within the areas they were assigned to patrol. These houses were not constructed by the district. Rather, they were incidentally acquired as pre-existing structures located on property obtained by the district. Although participants in the resident watchman program were not paid additional compensation for their services as resident watchmen, they were allowed to live in the residences rent free.

A prospective resident watchman must file an application for permit in which he agrees to (1) maintain a telephone in his residence at his own expense; (2) answer emergency and fire calls at all times; (3) remain on areas, in fire season, at all times; and (4) maintain his residence at his own expense. Once accepted as a resident watchman, he receives a document listing his specific duties as follows:

> 1. You must be thoroughly familiar with District boundaries within your assigned area and make periodic inspections to make certain that District property is protected.
>
> 2. Check for encroachments especially by home owners living adjacent to District lands.
>
> 3. Be on constant watch for fires. During times of extreme fire dangers, all residents must remain on his respective area at all times. You are required to have in your possession either a fire flapper or back pack pump. You will

be required to report to Division headquarters for weekend fire watch duty in times of extreme fire danger.

4. Check your area frequently during the hunting season. Report all hunters to your Division Superintendent immediately. Do not try to apprehend them.

5. You are expected to clean all minor debris dumping incidents. Report all major dumpings at once.

6. Check all water bodies for picnic tables and other objects and report same to the Division Superintendent.

7. Check all facilities for vandalism. Do not apprehend vandals, but try to obtain positive identification for authorities. (i.e. make, model, and license number of car if available).

8. Complete and submit resident watchman reports on a monthly basis.

During the years in issue, the resident watchmen did not possess police powers nor did they wear uniforms or badges identifying them as park employees.

Edward Vanicek

Edward Vanicek (Edward) was employed as a heavy equipment operator by the district in 1932. Edward was appointed a resident watchman in 1937.

During the years in issue, Edward was employed as a Maintenance Supervisor II by the district. As a maintenance supervisor, Edward was in charge of the central equipment garage located in downtown Chicago, several miles from the district's general headquarters. Edward generally worked at the garage on weekdays from 8 a.m. until 4 p.m.

In addition to his employment as a maintenance supervisor, Edward also served as a resident watchman during the years in issue. As a resident watchman, Edward, with his wife, Sara, resided in District Property No. 115 and District Property No. 525 rent free from 1972 through May 15, 1973, and from May 15, 1973 through 1974, respectively. For purposes of this opinion, the parties agree that during the years in issue, the monthly fair rental value of District Property No. 115 and District Property No. 525 was $275 and $475, respectively.

As a resident watchman of District Property No. 115 and District Property No. 525, Edward was responsible for an area consisting of approximately 365 acres and 824 acres, respectively. The designated area surrounding Property No. 115 included reforestation beds, an overflow parking lot, a boat launch, and a shelter. The minimum value of this property during the years in issue was $313,200. The designated area surrounding Property No. 525 included several picnic groves and a nature preserve. The minimum value of this property during the years in issue was $950,625. A substantial portion of the designated areas surrounding Edward's residences at Property No. 115 and Property No. 525 was visible from those residences.

During the years in issue, Edward patrolled his designated area 2 to 3 times per week on foot and in his automobile. While living at Property No. 115, Edward and his wife also observed their designated area several times a day from inside their house through field glasses.

Edward maintained a fire flapper[2] and a backpack pump in his home and carried these devices while patrolling to extinguish small fires which he might discover. In the event Edward discovered large fires or other emergencies which required assistance, he would call the appropriate division headquarters.

During the years in issue, Edward paid the following expenses incident to the use, repair, and maintenance of Properties Nos. 115 and 525:

Property No. 115	*1972*	*1973 (5 Months)*
Electric	$376.04	$175.48
Gas	315.92	139.53
Telephone	135.84	60.51
Water (well)	0	0
Improvements, repairs, or alterations	Unknown	Unknown

Property No. 525	*1973 (7 Months)*	*1974*
Electric	$314.65	$636.50
Gas	201.41	365.98
Telephone	84.71	155.40
Water	43.94	101.17
Improvements, repairs, or alterations	Unknown	Unknown

John B. Moden

John Moden (John) was employed in 1959 as a laborer for the Billy Caldwell Golf Course, one of eight public golf courses owned and operated by the district. John was promoted to golf course manager in 1960 and held that position until his retirement in June 1977. Simultaneous with his promotion to golf course manager, petitioner accepted appointment as resident watchman at District Property No. 207 located at the fifth tee on the Billy Caldwell Golf Course. John's duties as golf course manager and resident watchman often overlapped.

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[2] A fire flapper consists of a rubber pad attached to a long handle. The user pulls the fire flapper across a fire to smother it.

The job description for a golf course manager prepared by the district provided as follows:

> JOB SUMMARY:
>
> Operates and maintains one of seven district golf courses. Trains and instructs cashiers, checkers, and greenskeeping personnel. Responsible for all money collected on the course. Directly supervises Laborers involved in the maintenance and operation of the golf course.
>
> TYPICAL DUTIES:
>
> Checks all golf course mobile equipment to insure that its operating condition is satisfactory. Assigns men to their respective duties. Insures that greens and fairways have been mowed and ball washers cleaned and filled. Checks daily time sheet reports.
>
> Checks course regularly throughout the day. Insures the smooth operation of the golf course between twelve and fourteen hours a day, seven days a week. Trains assistants and laborers in the operation of all manual and mechanized equipment. Maintains inventory of tools, materials, equipment and supplies.
>
> Analyzes turf and soil conditions and determines necessary measures required to grow and maintain a healthy grass. Determines watering schedules, treatment of turf diseases, fertilization schedules, turf propagation methods, chemical soil analysis, chemical weed control, and soil aeration needs. * * *
>
> The duties listed are not set forth for purpose of limiting the assignment of work. They are not to be construed as a complete list of the many duties normally to be performed under a job title or those to be performed temporarily outside an employee's normal line of work.

In addition to the above-listed duties, John would (1) patrol the golf course 2 to 3 times each evening; (2) investigate disturbances on the golf course at night; (3) answer calls to the golf course on a telephone in his residence listed in the name of the golf course; and (4) monitor and safeguard various tools, materials, equipment, and supplies that were stored in a service building adjacent to John's residence. More than 85 percent of the golf course was visible from John's residence.

During the years in issue, the monthly fair rental value of Property No. 207 was $150 per month. The minimum value of the land, equipment, and buildings situated on the Billy Caldwell Golf Course was $707,680.

On their Federal income tax returns for the years in issue, petitioners did not report as income the fair rental value of lodging furnished to them rent free as participants in the district's resident watchman program. In the statutory notice of deficiency, respondent determined that petitioners should have reported this amount as income.

OPINION

The first issue for decision is whether petitioners are entitled to exclude from gross income the fair rental value of lodging furnished to them by their employer.

Gross income is defined in section 61 to include all income from whatever source derived, including compensation for services. It includes income realized in any form, i.e., money, property, or services. Sec. 1.61-2(d)(1), Income Tax Regs. If compensation for services is paid in the form of property, the fair market value of the property must be included in income. Sec. 1.61-2(d), Income Tax Regs. In the instant case, although Edward was not required to live in his lodgings to perform his duties as maintenance supervisor, the parties agree that the lodgings were furnished to him because of his employment as a resident watchman. The parties also agree that John received the rent-free use of his lodgings because of his employment as both resident watchman and golf course manager. Consequently, the value of such lodgings is includable in petitioners' gross income for the years in issue, unless specifically excludable under another provision of the Code. *Commissioner v. Duberstein*, 363 U.S. 278 (1960); *Commissioner v. LoBue*, 351 U.S. 243 (1956). Petitioners contend that the value of their lodgings is excludable under section 119.

Section 119 grants an exclusion for lodging furnished to an employee by his employer if three conditions are met: (1) The lodging is furnished for the convenience of the employer; (2) the lodging is on the business premises of the employer; and (3) the employee is required to accept the lodging as a condition of his employment.[3] The failure of petitioners to meet any one of these requirements will cause the value of their lodgings to be included in gross income. *Dole v. Commissioner*, 43 T.C. 697, 705 (1965), affd. per curiam 351 F.2d 308 (1st Cir. 1965). Respondent contends that petitioners failed to meet all three of the statutorily imposed conditions. His determination is presumptively correct and petitioners have the burden of proving error in this determination. Rule 142(a). On the facts before us, we believe that petitioners have satisfied their burden of proof.

We must first determine whether petitioners were required to accept their lodging as a condition of their employment. According to the relevant regulations, the "condition of employment" test is satisfied if an employee is—

> required to accept the lodging in order to enable him properly to perform the duties of his employment. Lodging will be regarded as furnished to enable the employee properly to perform the duties of his employment when, for example, the lodging is furnished because the employee is required to be available for duty at all times *or* because the employee could not perform the services required of him unless he is furnished such lodging. * * * [Sec. 1.119-1(b), Income Tax Regs. Emphasis supplied.]

We observe that the conditions stated in the last sentence of the above-quoted regulation are stated in the disjunctive. Admittedly, neither John, nor especially Edward, was required to be available for duty at all times. Nevertheless, the requirements of the regulation can be met if performance of the watchmen services required that the lodging be furnished to the employee. Respondent contends that petitioners' duties as resident watchmen did not require their occupancy of the lodging. We disagree.

Petitioners, as resident watchmen, were required to be on call to respond to fires and other emergencies which might develop in their designated areas at night. The strategic location of petitioners' residences within their designated areas enabled the district to rely on petitioners' prompt response to any emergency that might arise. We therefore find that petitioners were required to accept their lodging as a condition of their employment. See *Benninghoff v. Commissioner*, 71 T.C. 216 (1978), affd. per curiam 614 F.2d 398 (5th Cir. 1980).

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[3] For the years in question, sec. 119 provided:

SEC. 119. MEALS OR LODGING FURNISHED FOR THE CONVENIENCE OF EMPLOYER.

There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—

(1) in the case of meals, the meals are furnished on the business premises of the employer, or

(2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of his employment.

Effective Nov. 9, 1978, sec. 205 of Pub. L. 95-615, 92 Stat. 3107, amended sec. 119 in certain ways not germane to the issues presented in this case.

We also find that petitioners' lodgings were furnished for the convenience of the district. The "convenience of employer" test is essentially the same as the "condition of employment" test. *United States Junior Chamber of Commerce v. United States*, 334 F.2d 660, 663 (Ct. Cl. 1964). Thus, for the reasons stated above, we also find that petitioners have satisfied the "convenience of employer" test.

To exclude the value of their lodgings from income under section 119, petitioners must also satisfy their burden of proving that their lodgings were located on the business premises of the district.

The regulations provide that "the term 'business premises of the employer' generally means the place of employment of the employee." Sec. 1.119–1(c)(1), Income Tax Regs. Since Edward and John performed all of their watchmen services on the district's property where the houses were located, the short answer would seem to be that the lodgings were located on the business premises of the employer. The reported cases support the conclusion that the short answer is the right answer.

Lodging is considered located "on the business premises of the employer" if such lodging is furnished at a place where the employee performs a significant portion of his duties or on the premises where the employer conducts a significant portion of his business. *McDonald v. Commissioner*, 66 T.C. 223, 230 (1976). We have also held that lodging is located on the business premises of the employer if (1) the living quarters constitute an integral part of the business property or (2) the company carries on some of its business activities there. *Dole v. Commissioner*, 43 T.C. 697, 707 (1965), affd. per curiam 351 F.2d 308 (1st Cir. 1965). The extent or boundaries of the business premises in each case is a factual question whose resolution follows a consideration of the employee's duties as well as the nature of the employer's business. *Lindeman v.*

Commissioner, 60 T.C. 609 (1973). "The touchstone of the business premises test is the lodging's relationship to the business activities of the employer." That is, "The property must bear an integral relationship to the business activities of the employer." *Benninghoff v. Commissioner, supra* at 221.

Respondent does not dispute that petitioners' residences were located on land owned by their employer, the district. Respondent argues, however, that petitioners' lodgings were not integrally related to the business activity of the district. We disagree.

The parties stipulated, without citation to the relevant authority, that the legislation which created the Forest Preserve District described the nature of the district's business as follows:

> To acquire * * * and hold lands * * * containing one or more natural forests * * * for the purpose of protecting and preserving the flora, fauna and scenic beauties within such district, and to restore, restock, protect and preserve the natural forests and said lands together with their flora and fauna, as nearly as may be, in their natural state and condition, for the purpose of the education, pleasure, and recreation of the public.

Thus, during the years in issue, a major business activity of the district was to protect and preserve approximately 64,000 acres of land for the public's education, pleasure, and recreation.

Petitioners' appointments as resident watchmen and their occupancy of strategically located residences were an integral part of the district's efforts to protect and preserve the district's more than 64,000 acres of land. As resident watchman of the Billy Caldwell Golf Course, John was required to safeguard the golf course as well as various tools, materials, equipment, and supplies that were stored in a service building adjacent to John's residence. Because John could observe more than 85 percent of the golf course from his residence on the fifth tee, his strategically located residence enabled him to continuously monitor a substantial portion of the golf course and service building, 24 hours a day. Indeed, John testified at trial that as a result of his location on the golf course, he was alerted to, and consequently able to respond to, parties taking place on the greens and vandals intending to damage the greens.

Similarly, the strategic location of Edward's seriatim residences within his designated areas enabled him to perform his resident watchman duties at Properties Nos. 115 and 525 during each of the periods during which he resided on these respective properties. From these residences, Edward was able to observe a substantial portion of his designated areas and therefore was able to continuously monitor those areas for fire, hunting, and vandalism. The strategic location of Edward's residences also allowed him to quickly respond to any problem he might discover. The district's ability to rely on Edward's quick response to problems was especially important during the hours of 1 a.m. to 9 a.m. when the rangers were off duty. During this period of time, the resident watchmen were often the first people called by the district's general headquarters to respond to emergencies arising in their designated areas.

A major business activity of the district was the protection and preservation of more than 64,000 acres of land. The district's primary reason for providing these residences to petitioners was to enable them to protect their designated areas from fire, vandalism, hunting, and other encroachments. Indeed, we are convinced that petitioners' location at these residences was integral and essential to the performance of their duties as resident watchmen. Consequently, we must conclude that petitioners' residences were integrally related to a major business activity of the district.

Respondent, relying on *Benninghoff v. Commissioner, supra*, argues that in the absence of petitioners' performance of significant employer activities at their residences, we cannot find that petitioners' residences were located on the district's business premises. In *Benninghoff*, the Canal Zone Government required the taxpayer, a member of the Canal Zone police, to accept lodging in the Canal Zone District in which he was employed. Although the taxpayer was required always to be available for duty and to maintain a specially equipped telephone in his residence, we held that the mere fact that the taxpayer was required to live somewhere in the Canal Zone (as were all Government employees) did not justify a holding that the taxpayer's residence was located on the business premises of his employer. In so holding, we found that "the Canal Zone Government furnished the apartment as a purely personal residence and not as an integral part of its business operations.

Nor did it require substantial employment activities by [taxpayer] in the residence." 71 T.C. at 223.

Without doubt, the performance of significant employer activities at the taxpayer's residence is often an important factor to consider in determining whether lodgings are located on the business premises of an employer; nevertheless, we do not believe that the absence of this factor is determinative in every case. To argue, as respondent seems to be arguing, that the conditions of section 1.119–1(b), Income Tax Regs., can only be met by the performance of services within the four walls of a structure strikes us as illogical. Both Edward and John were required to be watchmen, both from within their respective strategically located residences and by "walking the territory." Thus, while we agree with respondent that "business premises" is not an infinitely elastic concept, we do not believe that its parameters are to be as severely circumscribed as respondent contends. Accordingly, we find that petitioners are entitled to exclude from gross income under section 119 the fair rental value of their residences. We therefore need not consider petitioners' alternative arguments for exclusion.

The next issue for decision is whether the Vaniceks are entitled to deduct under section 162 certain utility expenses incurred in operating their residences. Edward contends that these expenses were incurred in carrying on his business as a resident watchman. Specifically, Edward contends that because his lodgings would not be usable for performing the functions of a resident watchman unless they were provided with basic utilities, such expenses are deductible as ordinary and necessary business expenses under section 162(a).

Section 162(a) allows a taxpayer to deduct all ordinary and necessary business expenses paid or incurred during the taxable year. However, a taxpayer's personal or living expenses are not deductible. Sec. 262. Although we agree with Edward that the portion of his utility expenses allocable to his business use of the residences would be deductible under section 162(a), the record contains no evidence from which we could reasonably apportion the utility expenses between Edward's business and personal use of the residences. While it is within the purview of this Court to estimate the amount of allowable deductions where there is evidence that deductible expenses were incurred (*Cohan v. Commissioner*, 39 F.2d 540

(2d Cir. 1930)), we must have some basis on which an estimate may be made. *Williams v. United States*, 245 F.2d 559 (5th Cir. 1957). Because the record contains no evidence upon which we could base such an estimate, we find that the Vaniceks have failed to prove that they are entitled to claim any deductions under section 162(a). Rule 142(a).

To reflect the foregoing,

Decision will be entered under Rule 155 in docket No. 16187–79.

Decision will be entered for the petitioners in docket No. 16201–79.

VIRGINIA EDUCATION FUND, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2960–79X. Filed November 12, 1985.

P seeks declaratory judgment under sec. 7428, I.R.C. 1954, as amended. P solicits funds for distribution to certain private schools. In 1961, R issued P a ruling that P was exempt from Federal income tax under sec. 501(c)(3), I.R.C. 1954, as amended. In 1972 R proposed in writing to P the revocation of P's exempt status. In 1978, R issued P a determination letter revoking such status retroactively to 1974. *Held*, burden of proving nondiscriminatory character of schools remained on P. *Held, further*, revocation is effective retroactively to 1974.

John W. Pearsall, for the petitioner.
Michael F. Patton, for the respondent.

OPINION

COHEN, *Judge*: Respondent revoked a ruling classifying petitioner as an organization exempt from Federal income tax under section 501(c)(3).[1] Petitioner challenges respondent's determination and has invoked the jurisdiction of this Court for a declaratory judgment pursuant to section 7428. The issues for decision are the apportionment of the burden of proof between the parties and the validity of respondent's making the revocation retroactive to 1974.

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[1] Unless otherwise indicated all section references are to the Internal Revenue Code of 1954, as amended.

Petitioner was organized in Virginia on May 8, 1958, as a nonstock membership corporation for charitable, educational, and literary purposes, under the name of Defenders Welfare and Educational Foundation. Petitioner solicits funds from private sources and distributes those funds to private schools (the donee schools). It does not operate any schools.

Chronology

Soon after its organization, petitioner applied for an exemption from Federal income tax as an organization described in section 501(c)(3). In the application petitioner stated that it was formed "To assist local organizations in Virginia in the operation of private schools in those localities where public schools are closed." On April 7, 1961, the Internal Revenue Service (Service) National Office issued a ruling classifying petitioner as a 501(c)(3) organization.

On July 10, 1970, the Service publicly announced, in a reversal of its previously published position, that it would deny tax-exempt status to racially discriminatory private schools. This post-1970 position is embodied in Rev. Rul. 71–447, 1971–2, C.B. 230, 231, which provides, in relevant part:

> a school not having a racially nondiscriminatory policy as to students is not "charitable" within the common law concepts reflected in sections 170 and 501(c)(3) of the Code and in other relevant Federal statutes and accordingly does not qualify as an organization exempt from Federal income tax.

Rev. Rul. 71–447, 1971–2 C.B. at 230, defines a "racially nondiscriminatory policy as to students" as meaning:

> that the school admits the students of any race to all the rights, privileges, programs, and activities generally accorded or made available to students at that school and that the school does not discriminate on the basis of race in administration of its educational policies, admissions policies, scholarship and loan programs, and athletic and other school-administered programs.

On January 11, 1972, the Service District Director sent petitioner a letter proposing an adjustment in petitioner's tax-exempt status. The revenue agent's examination report, which accompanied the letter, recommended the revocation of petitioner's exempt status effective December 31, 1968. The stated reason for the recommendation was as follows:

> more than 50% of the funds disbursed in 1969 was disbursed to organizations which had not established exempt status, and the Virginia Education Fund has been unable to establish that these are organizations described in section 501(c)(3) of the Code, and in addition no adequate controls were maintained to insure that the funds disbursed were used for purposes described in section 501(c)(3) of the Code * * *

On April 20, 1973, the District Director, at petitioner's request, sent petitioner a copy of a technical advice memorandum from the National Office dated March 14, 1973, which analyzed the proposed revocation of petitioner's exempt status. The memorandum stated, in relevant part:

> The file indicates that the Fund is supporting segregated schools. * * *

* * * * * * *

> In a News Release, dated July 10, 1970, the Internal Revenue Service announced that it could no longer legally justify allowing tax-exempt status to private schools that practice racial discrimination nor could it treat gifts to such schools as charitable deductions for income tax purposes. The action of the Service on July 10, 1970, marked a decision that the changes in the public policy of the United States could no longer be disregarded as a disqualifying factor with respect to the charitable status of the institutions involved. This position is reflected in Revenue Ruling 71–447.

* * * * * * *

> Since the Internal Revenue Service did not determine until July 10, 1970, that it could no longer legally justify recognizing the tax exempt status of schools with racially discriminatory admissions policies, the Fund is not required to show that the schools receiving funds during the year 1969 had racially nondiscriminatory admissions policies. Therefore, the Fund qualifies for recognition of exemption under section 501(c)(3) of the Code for the year 1969.

On November 11, 1976, the District Director sent petitioner a letter proposing an adjustment to petitioner's exempt status. The accompanying examination report of the revenue agent stated, in relevant part:

> You have supported organizations that have not adopted racially nondiscriminatory policies as to students and the exempt status of the organizations has been revoked in accordance with the provisions of Revenue Ruling 71–447. You are not regarded as operated exclusively for exempt purposes as

> provided in Regulations 1.501(c)(3)–1(c). It is recommended that your exempt status be revoked with retroactive effect to the calendar year 1974.

On May 24, 1977, the District Director issued petitioner a determination letter revoking the Service's April 7, 1961, ruling that petitioner was exempt from tax. The determination letter stated, in relevant part:

> During the year 1974 you received contributions in the total amount of $107,733 and you distributed $93,668 to seven different schools which failed to qualify for exemption from Federal income tax because they declined to adopt racially nondiscriminatory admission policies. Information indicates that 79 percent of your contributions for the year 1975 were made to the same schools and they received 75 percent of the total contributions you made during the period January 2 to May 18, 1976. Advance assurance of the deductibility of contributions to the schools was suspended for gifts made after January 14, 1974 as announced in Revenue Announcement 74–1.
>
> * * * * * * *
>
> Regulations 1.501(c)(3)–1(c) provide that "an organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."
>
> In view of the foregoing, it is the determination of this office that you are not exempt from Federal income tax because you are not operated exclusively for exempt purposes specified in section 501(c)(3) of the Internal Revenue Code. Accordingly, our ruling dated April 7, 1961 is hereby revoked with retroactive effect to the year ended December 31, 1974.

On December 22, 1978, the Service reissued the May 24, 1977, determination letter so that petitioner might take advantage of the declaratory judgment procedure prescribed in section 7428.[2] The December 22, 1978, letter stated, in relevant part:

> During 1974, a substantial portion of your contributions were [sic] distributed to schools which failed to qualify for exemption from Federal income tax because they did not adopt a racially nondiscriminatory admissions policy in accordance with Revenue Ruling 71–447 and subsequent revenue procedures.
>
> * * * * * * *

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[2] Codified by sec. 1306 of the Tax Reform Act of 1976, Pub. L. 94–455, 90 Stat. 1525, 1717–1720, sec. 7428 applies to Service determinations made after Jan. 1, 1976.

> Section 1.501(c)(3)-1(c) of the Income Tax Regulations provides that "an organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in Section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose."
>
> In view of the foregoing, it is the determination of this office that you are not exempt from Federal income tax because you are not operated exclusively for exempt purposes specified in Section 501(c)(3) of the Internal Revenue Code. Accordingly, our ruling dated April 7, 1961 is hereby revoked with retroactive effect to the year ended December 31, 1974.

Having satisfied all jurisdictional prerequisites, on March 12, 1979, petitioner filed its petition for a declaratory judgment requesting that the Court affirm its tax-exempt status under section 501(c)(3).

On September 14, 1981, petitioner filed a motion for summary judgment. In a memorandum supporting the motion, petitioner alleged that the only ground for revoking petitioner's tax-exempt status stated in the December 22, 1978, determination letter was that the donee schools "did not adopt a racially nondiscriminatory admissions policy in accordance with Revenue Ruling 71-447 and subsequent revenue procedures." Those "subsequent revenue procedures" were identified in the memorandum as Rev. Proc. 72-54, 1972-2 C.B. 834, and Rev. Proc. 75-50, 1975-2 C.B. 587 (superseding Rev. Proc. 72-54), which set forth,

> guidelines and recordkeeping requirements for determining whether private schools that are applying for recognition of exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954, or are presently recognized as exempt from tax, have racially nondiscriminatory policies as to students. [Rev. Proc. 75-50, 1975-2 C.B. at 587.]

Petitioner argued that failure to comply with the guidelines in the revenue procedures was not determinative of an organization's exempt status and that under Rule 217(c)[3] respondent bore the burden of proving petitioner's nonexempt status based upon any grounds other than the donee schools' noncompliance with the revenue procedures. Petitioner concluded that summary judgment in its favor was appropriate because respondent had not investigated any of the donee schools to determine whether they had actually adopted racially nondiscriminatory policies.

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[3] Unless otherwise indicated any references to Rules shall be deemed to refer to the Tax Court Rules of Practice and Procedure.

By order dated January 4, 1982, the Court denied petitioner's motion for summary judgment. We reasoned as follows:

> Petitioner's position is that the determination of revocation is premised solely on its donee schools' failure to follow the affirmative action publicity guidelines of the revenue procedures. It admits that the donee schools have not taken the necessary steps regarding publicity and it urges that consequently there is no genuine issue as to any material fact. However, the revenue ruling and the revenue procedure go deeper. Basically, what is required is the adoption of a racially nondiscriminatory policy and actual operation in accordance with such a policy.
>
> Respondent has been candid in admitting that he has not investigated any of the donee schools to determine whether, in fact, they have adopted racially nondiscriminatory policies, and are operating in accordance with such policies if, in fact, they have been adopted. Respondent's position is that he need not have done so. It is believed that respondent's position is a sound one. There is a positive indication in the administrative record that petitioner was "set up simply to act as a receptacle for contributions from any source interested in preserving segregated schools, and passing on those contributions to the various organizations actively operating such schools in those localities faced with court orders to integrate the public schools." (Exhibit N) Moreover, the pleadings and admissions establish that petitioner's donee schools were part of a group of intervenors in the case of *Gonzales v. Fairfax-Brewster School, Inc.*, 363 F. Supp. 1200 (E.D. Va. 1973), affirmed sub nom. *McCrary v. Runyon*, 515 F.2d 1082 (4th Cir. 1975), affirmed 427 U.S. 160 (1976). The trial court enjoined the defendants and the intervenors from following a policy with respect to the admission of students of discriminating on the basis of race or color, which action was affirmed by both the Court of Appeals and the Supreme Court. Given the stated purpose for petitioner's formation and its donee schools' involvement in the cited case, it must be found that the respondent was prima facie correct in his determination of revocation of petitioner's exempt status. *The burden is upon petitioner to establish that its donee schools have adopted racially nondiscriminatory policies and are operating in good faith in accordance with such policies.* Discharge of that burden entails obvious genuine issues of material facts.
>
> In this revocation action, as distinguished from most other declaratory judgment actions in this Court, the Court's decision must be based upon a trial on the merits as is true in the ordinary deficiency case, and not solely upon the materials contained in the administrative record. Rule 217(a). It goes without saying that denial of petitioner's motion for summary judgment is in no way a conclusion that the petitioner's exemption has been properly revoked. Petitioner will have full and ample opportunity to establish, as it must, that its donee schools have "cleaned up their acts," so to speak.
>
> [Emphasis supplied.]

On January 24, 1985, the Court ordered the parties to appear at a hearing in Washington, D.C., to discuss the procedure for a trial or other evidentiary proceeding in this case. At that hearing, petitioner's counsel stated that petitioner did not wish to present any evidence and that the Court should enter a decision as a matter of law based upon "Respondent's December 22, 1978 letter of revocation * * * [and] the various pleadings filed in this Tax Court proceeding, not treating the administrative record as a pleading."[4]

Burden of Proof

In *Bob Jones University v. United States*, 461 U.S. 574 (1983), the Supreme Court adopted the rationale of Rev. Rul. 71-477 and held that racially discriminatory private schools do not qualify for exemption under section 501(c)(3). See also *Green v. Connally*, 330 F. Supp. 1150 (D.D.C. 1971), affd. per curiam sub nom. *Coit v. Green*, 404 U.S. 997 (1971). Moreover, petitioner does not deny that its exempt status depends upon the donee schools' entitlement to exempt status. There is no evidence that the donee schools maintained nondiscriminatory policies and hence were tax exempt under section 501(c)(3). Thus the issues before us are purely procedural.

The first issue is identical to that raised by petitioner in the earlier motion for summary judgment, i.e., whether respondent bears the burden of proving the discriminatory character of the donee schools because the only ground for revocation stated in the December 22, 1978, determination letter was the failure of the schools to comply with the guidelines of the revenue procedures.

We disposed of this issue in our Memorandum Sur Order explaining our reasons for denying petitioner's motion for summary judgment. Petitioner has acknowledged that the prior order is the law of this case unless modified by us. We are not persuaded that our prior order was wrong.

Section 7428 grants this Court nonexclusive jurisdiction to issue a declaratory judgment regarding the initial or continuing qualification of an organization under section 501(c)(3). Although section 7428 does not prescribe rules governing the burden of proof in such proceedings, Congress intended that the courts develop such rules conforming, insofar as practical, to this Court's rules relating to burden of proof in retirement plan actions under section 7476. See H. Rept. 94–658 (1975), 1976–3 C.B. (Vol. 2) 695, 977–978; Staff of Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976 (1976), 1976–3 C.B. (Vol. 2) 1, 415. Promulgated under this congressional directive, Rule 217(c) provides, in relevant part:

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[4] Petitioner refused to join respondent in filing the administrative record herein. Respondent therefore unilaterally certified and filed the entire administrative record. See Rule 217(b)(1).

> (c) Burden of Proof: The burden of proof in declaratory judgment actions shall be as follows:
>
> * * * * * * *
>
> (2) *Other Actions*: (i) *Petitioner*: The burden of proof shall be upon the petitioner as to jurisdictional requirements and as to the grounds set forth in the notice of determination. * * *
>
> (ii) *Respondent*: The burden of proof shall be upon the respondent as to any ground upon which he relies and which is not stated in the notice of determination. * * *[5]

We thus must carefully scrutinize the language of respondent's determination letter to determine the specific issues raised therein (*Goodspeed Scholarship Fund v. Commissioner*, 70 T.C. 515 (1978)) and place the burden of proof upon respondent with respect to any grounds for denial of exemption not raised in the determination letter. See, e.g., *Dumaine Farms v. Commissioner*, 73 T.C. 650, 659–660 (1980); *Peoples Translation Service v. Commissioner*, 72 T.C. 42, 51–52 (1979); cf. *Ralph Gano Miller Corp. v. Commissioner*, 76 T.C. 433, 436 (1981) (new ground in proceeding under section 7476).

The present case does not involve such a "new ground," however. Petitioner's failure to satisfy the operational test of section 1.501(c)(3)–1(c), Income Tax Regs., due to the discriminatory character of the donee schools was the ground raised in the December 22, 1978, determination letter and is the only ground in issue herein. Respondent does not challenge any other aspect of petitioner's organization or operation. Cf. *Dumaine Farms v. Commissioner, supra; Peoples Translation Service v. Commissioner, supra*.

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[5] Rules 210 through 218 (Title XXI) prescribe special provisions applying to the various declaratory judgment actions over which this Court has jurisdiction.

Petitioner apparently interprets respondent's final determination letter as relying upon the revenue procedures as the sole legal authority for the nonexempt status of the donee schools. Such an interpretation would indeed be anomalous, because the procedures are merely guidelines representing the position of the Service and not substantive law. See *Prince Edward Sch. Foundation v. United States*, 478 F. Supp. 107, 112 (D.D.C. 1979), affd. without published opinion (D.C. Cir., July 23, 1980), cert. denied 450 U.S. 944 (1981); cf. *Pitcher v. Commissioner*, 84 T.C. 85, 93 (1985).

In cases involving the analogous question of what constitutes a "new matter" not raised in respondent's notice of deficiency for the purpose of Rule 142(a), we have articulated the following test:

> The assertion of a new theory which merely clarifies or develops the original determination without being inconsistent or increasing the amount of the deficiency is not a new matter requiring the shifting of the burden of proof. *Estate of Jayne v. Commissioner*, 61 T.C. 744, 748–749 (1974); *McSpadden v. Commissioner*, 50 T.C. 478, 492–493 (1968); *Estate of Sharf v. Commissioner*, 38 T.C. 15, 27–28 (1962). However, if the assertion in the amended answer either alters the original deficiency or requires the presentation of different evidence, then respondent has introduced a new matter. *Estate of Falese v. Commissioner*, 58 T.C. 895, 898–899 (1972); *McSpadden v. Commissioner, supra; Papineau v. Commissioner*, 28 T.C. 54, 57 (1957); *Tauber v. Commissioner*, 24 T.C. 179, 185 (1955). * * * [*Achiro v. Commissioner*, 77 T.C. 881, 890 (1981).]

See also *Stewart v. Commissioner*, 714 F.2d 977, 990–991 (9th Cir. 1983), affg. a Memorandum Opinion of this Court. In the present case, the citation of Service guidelines in the determination letter is not inconsistent with the presentation of evidence not addressed in the guidelines.

The procedural history of this case indicates that petitioner was well aware from the outset that respondent's sole and unambiguous ground for revocation of petitioner's exemption rested upon the character of the donee schools. Petitioner's overly semantical argument designed to obviate its responsibility under Rule 217(c) "is purely technical, and does not go to the heart of the matter." *J.T. Slocomb Co. v. Commissioner*, 334 F.2d 269, 273 (2d Cir. 1964). Because petitioner has not introduced evidence establishing its exempt status, we must uphold respondent's revocation of that status.

Retroactivity

The remaining issue for decision is the effective date of such revocation. Petitioner argues that, even if it is not entitled to exemption under section 501(c)(3), respondent improperly made the December 22, 1978 revocation of his earlier ruling retroactive to 1974.

Section 7805(b) provides:

> SEC. 7805(b). RETROACTIVITY OF REGULATIONS OR RULINGS.—The Secretary may prescribe the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect.

The Supreme Court has held that the Commissioner has broad discretion, under section 7805(b) and its predecessor, in deciding whether to revoke a ruling retroactively and that his determination is reviewable by the courts only for abuse of that discretion. *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 184 (1957); see *Dixon v. United States*, 381 U.S. 68 (1965).

Through section 601.201(n)(6)(i), Statement of Procedural Rules, the Secretary has limited the Commissioner's discretion to revoke retroactively a favorable ruling on exempt status. The rule provides:

> (i) An exemption ruling or determination letter may be revoked or modified by a ruling or determination letter addressed to the organization, or by a revenue ruling or other statement published in the Internal Revenue Bulletin. The revocation or modification may be retroactive if the organization omitted or misstated a material fact, operated in a manner materially different from that originally represented, or engaged in a prohibited transaction of the type described in subdivision (vii) of this subparagraph. In any event, revocation or modification will ordinarily take effect no later than the time at which the organization received written notice that its exemption ruling or determination letter might be revoked or modified. [Codified at 26 C.F.R. sec. 601.201(n)(6)(i) (1978).]

Petitioner contends that respondent can make revocation retroactive only if one of the three conditions in the second sentence of the above rule is present. In a case virtually indistinguishable from the present case, however, the District Court for the District of Columbia held that the third sentence of the rule prescribes the general effective date for revocation of an exemption ruling. *Prince Edward Sch. Foundation v.*

United States, 478 F. Supp. at 113. We agree with this interpretation. Although the rule could have been more artfully drafted, the prefatory language of the third sentence ("In any event") indicates that the sentence applies to cases not necessarily within the second sentence.

We thus conclude that respondent has not abused his discretion under section 7805(b) in revoking petitioner's exempt status retroactively to 1974. On January 11, 1972, petitioner received written notice that its exemption ruling might be revoked and thus, under the procedural rule, respondent could have made his revocation retroactive to that date.

Petitioner nevertheless urges us to strike down respondent's action as arbitrary and capricious under *Lesavoy Foundation v. Commissioner*, 238 F.2d 589 (3d Cir. 1956), revg. 25 T.C. 924 (1956). In that case the Court of Appeals for the Third Circuit held that the Commissioner abused his discretion in retroactively revoking a ruling where the taxpayer had in good faith relied upon the ruling. We need not decide whether *Lesavoy Foundation* possesses continuing validity after *Automobile Club of Michigan v. Commissioner, supra*, and *Dixon v. United States, supra*. Compare *Wisconsin Nipple & Fabricating Corp. v. Commissioner*, 581 F.2d 1235, 1238–1239 (7th Cir. 1978), affg. 67 T.C. 490 (1976), with *Pittsburgh Press Club v. United States*, 615 F.2d 600, 606 (3d Cir. 1980). As of 1974, petitioner could not claim good faith reliance upon the 1961 exemption ruling. In addition to the January 11, 1972, letter, the publication of Rev. Rul. 71–447, 1971–2 C.B. 230, gave petitioner advance notice of the change in the Service's position (cf. *Wisconsin Nipple & Fabricating Corp. v. Commissioner*, 67 T.C. 490, 497–498 (1976), affd. 581 F.2d 1235 (7th Cir. 1978)), and the April 20, 1973, technical advice memorandum indicated that petitioner's exempt status would not be revoked for 1969 only because the change in position occurred after that year.[6]

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[6] Petitioner attached to its reply brief a letter from the District Director dated Sept. 14, 1976, which summarily stated that there would be no change in petitioner's exempt status for 1973. This letter was not included in the certified administrative record filed with the Court. Although we may consider evidence outside the administrative record in revocation proceedings, such evidence must be presented to the Court in accordance with the Rules governing trials. See Rule 217(a), (b) and accompanying notes; see also notes accompanying Rule 213(a), (b). Petitioner explicitly declined to present any additional evidence in this case. Moreover, even if the letter were included in the record herein, our decision would remain unchanged, because the letter does not indicate the reason for the Service's action.

We have held that the Commissioner further limited his discretion under section 7805(b) through Rev. Proc. 80-25, 1980-1 C.B. 667. *Presbyterian & Reform Pub. Co. v. Commissioner*, 79 T.C. 1070, 1089 (1982), revd. on other grounds 743 F.2d 148 (3d Cir. 1984). See also *Lansons, Inc. v. Commissioner*, 622 F.2d 774, 778 (5th Cir. 1980), affg. 69 T.C. 773 (1978). Because the effective date of Rev. Proc. 80-25 is June 30, 1980, subsequent to respondent's final determination letter, the revenue procedure does not affect our decision in the present case.[7]

Decision will be entered for the respondent.

PACCAR, INC., AND SUBSIDIARIES, PETITIONER V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 22221-82. Filed November 13, 1985.

Held: Transfers of surplus and obsolete inventory by petitioner to an unrelated warehouse facility did not constitute a sale due to petitioner's retention of dominion and control over the transferred material. Absent a sale, deductions for inventory losses based on scrap value of the material are impermissible. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979). *Held, further*: Respondent was not arbitrary is adjusting sales prices on truck units sold by petitioner to its wholly owned subsidiary. The proper amount of adjustment is determined from the facts in the record. The sales price on parts needs no adjustment as it is comparable to an arm's-length price.

John T. Piper and *Joseph A. McIntosh*, for the petitioner.

Blake W. Ferguson, *Michael R. McMahon*, and *Thomas N. Tomashek*, for the respondent.

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[7] Referring to rulings or determination letters recognizing exemption, Rev. Proc. 80-25, 1980-1 C.B. 667, 671, provides, in relevant part:

"In cases where a ruling or determination letter was issued in error or is no longer in accord with the holding of the Service, retroactivity of the revocation or modification ordinarily will be limited to a date not earlier than that on which the original ruling or determination letter is modified or revoked."

Compare Rev. Proc. 72-4, 1972-1 C.B. 706, 708 (superseded by Rev. Proc. 80-25), which was in effect on Dec. 22, 1978, and which provided rules for revocation of exemption rulings virtually identical to sec. 601.201(n)(6)(i), Statement of Procedural Rules.

SCOTT, *Judge*: Respondent determined deficiencies in petitioner's income taxes for the years and in the amounts as follows:

Year	*Deficiency*
1975	$566,352
1976	[1]1,578,202
1977	1,117,128

Some of the issues raised by the pleadings have been disposed of by agreement of the parties, leaving for our decision: (1) Whether petitioner's transfer of surplus and obsolete material to SAJAC, an unrelated warehouse facility, constituted a sale entitling petitioner to claimed deductions for inventory losses based on the scrap value of the materials transferred; (2) whether the 10-percent purchase discount petitioner granted its wholly owned subsidiary upon the sale to it of trucks and parts which were resold by the subsidiary in the foreign market represented a discount that would have been afforded unrelated parties dealing at arm's length and, if not, what is the proper adjustment, if any, under section 482.[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioner is a corporation organized under the laws of the State of Washington. It is engaged in the manufacture and distribution of transportation equipment. Petitioner operates through separate and independent divisions. At the time of filing its petition in this case, petitioner maintained its principal place of business in Bellevue, Washington. Petitioner and its subsidiaries filed consolidated Federal income tax returns on Forms 1120 for taxable years 1975, 1976, and 1977, with the Internal Revenue Service Center, Ogden, Utah.

Paccar Parts, a division of petitioner, sells heavy duty truck parts. Dart Truck Co. (Dart), a division of petitioner during the years in issue, is engaged in the manufacture and distribution of above-ground mining vehicles. Wagner Mining Equipment

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[1] In the stipulation, the parties agreed that pursuant to the statutory notice of deficiency dated June 14, 1982, respondent determined a deficiency for tax year 1976 in the amount of $1,578,128.

[2] Unless otherwise stated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years here in issue.

Co. (Wagner), a division of petitioner, is engaged in the manufacture and distribution of underground mining vehicles. Kenworth Truck Co. (Kenworth) and Peterbilt Motors Co. (Peterbilt), both divisions of petitioner, are engaged in the manufacture of trucks. Pacific Car & Foundry Co. (PC & F), also a division of petitioner, is engaged primarily in the manufacture of rail cars.

During the years in issue in this case, petitioner's inventory was valued on the LIFO method of accounting.

1. Transfer of Inventory to SAJAC

SAJAC Company, Inc. (SAJAC), is a Wisconsin corporation formed in 1971. SAJAC is in the business of storing slow moving excess parts from the inventory of large manufacturers throughout the United States. On November 15, 1976, November 30, 1976, and March 23, 1977, three divisions of petitioner, Paccar Parts, Dart, and Wagner, respectively entered into written agreements with SAJAC for the disposition of certain inventory. These agreements provided as follows:

> AGREEMENT
>
> This agreement, between ____, a division of PACCAR Inc., and SAJAC Company, Inc., whose principal place of business is at 1100 Green Valley Road, Beaver Dam, Wisconsin 53916.
>
> ____ hereby sells and SAJAC hereby accepts on the following terms and conditions set forth selective excess, inactive or unusable parts hereinafter referred to as scrap material.
>
> 1. SAJAC shall from time to time purchase from ____ scrap material at a price to be determined by the then prevailing market price in the Chicago area for scrap metals of like kinds, quality and weight.
>
> 2. Title to, property in and ownership of all scrap material shall pass to SAJAC upon delivery to a designated carrier at any ____ regional warehouse. All goods are sold F.O.B. seller's warehouse, and all risk of loss shall be borne by SAJAC.
>
> 3. SAJAC Company is not, in any manner, expressed or implied, a bailee of the scrap material, nor is SAJAC in any way an agent of ____.
>
> 4. ____ retains the right to repurchase any portion of the scrap material so sold for a period of at least four years after delivery of such goods to SAJAC. SAJAC will advise ____ of any other disposition of material during this period of time.
>
> 5. The repurchase cost to ____ shall not exceed 90% of ____ last acquisition cost, adjusted for inflation. If SAJAC's invoices to PACCAR exceed 10% of the inventory purchased from ____ in any calendar year, SAJAC will reduce its selling price on parts for the remainder of the year to 70% of PACCAR's

cost. If SAJAC's invoices to PACCAR exceed 20% of the inventory purchased from ____ in any calendar year, SAJAC will reduce the selling price on parts for the remainder of the year to 50% of PACCAR's cost.

6. After the expiration of said four year minimum period, SAJAC agrees to dispose of such goods by destroying, scrapping, dismantling, mutilating, or recycling in a commercially accepted manner. All of such goods shall be dismantled and otherwise made unusable. SAJAC agrees to notify ____ when goods are to be disposed of and will allow a PACCAR representative to be present at SAJAC facilities to witness disposal of said goods.

7. This Agreement shall inure to the benefit of and be binding upon the parties, their successors and assigns.

8. This Agreement may be canceled by either party by giving written notice to the other party, provided that such cancellation shall not be effective until sixty days after receipt of such written notice. In the event this Agreement is canceled, all goods then in the possession of SAJAC shall be destroyed, disposed of, scrapped, recycled or otherwise made unusable in accordance with paragraph 6.

Beginning in 1976, parts were transferred to SAJAC by the divisions of petitioner which had entered into the above agreement with SAJAC.

The chart on page 758 is a random sample of 10 parts transactions occurring in 1978 as if the 90-percent repurchase price applied between Paccar Parts and SAJAC.

A random parts transactions sample for 1976 and 1977 would show roughly similar proportional relationships between SAJAC's cost for the part and the reacquisition cost of petitioner.

Petitioner treated its transfers of material to SAJAC as sales for both accounting and tax purposes. SAJAC treated all transfers from petitioner as purchases for both accounting and tax purposes and accounted for these materials by including them in its inventory. Petitioner and SAJAC treated any "repurchases" as purchases and sales, respectively, for accounting and tax purposes.

During the years 1976 and 1977, SAJAC had no regional warehouse on the west coast. Any parts and materials petitioner disposed of to SAJAC from its west coast facilities were shipped to SAJAC's warehouses located in the Midwest, including Oklahoma. During 1976 and 1977, petitioner paid the shipping costs on materials it sent to SAJAC from its west coast locations.

Both the Kenworth and Peterbilt divisions of petitioner built heavy-duty trucks for sale domestically and abroad. In

Parts number and description	*Balance in PACCAR Parts inventory before shipment to SAJAC*	*Quantity of part sent to SAJAC from Chicago warehouse*	*Quantity of part to be sent to SAJAC from other PACCAR Parts warehouses*	*Approximate weight of part in pounds*	*SAJAC cost to acquire part from PACCAR Parts at 0.02/pounds*	*PACCAR Parts division cost to reacquire part from SAJAC*	*Price billed PACCAR dealer for part*
K053-217CP Bracket Chrome	2	2	0	1	$.02	$ 3.69	$ 7.85
904940–1 Slip Joint	1	1	0	42	.84	42.24	66.97
01871419 Post Assy - Side RH	4	4	0	19	.38	7.91	19.24
01871421 Spacer	5	5	0	2	.04	1.00	2.61
K188–61 STR Pump	5	4	1	37.5	.75	160.29	395.69
01869585 Striker Plate	9	5	4	1	.02	24.46	2.13
K054–1557 Bracket E haust	12	12	0	40	.80	30.16	65.76
K054–1094 BRKT - EXL	4	4	0	2	.02	.27	.62
K218–436 Sill - Floor L.N./K1000	2	2	0	20	.40	14.98	38.95
75828 Radiator Assy	1	1	0	255	5.10	363.98	589.92

addition, they sold replacement parts for these trucks. Paccar Parts warehouses and distributes heavy-duty truck parts for Kenworth and Peterbilt trucks and sells these parts to franchised dealers and overseas customers by using the facilities of petitioner's three marketing divisions, Kenworth, Peterbilt, and Paccar International. The trucking industry has a policy of supplying replacement parts for trucks for 7 years from the date the truck was manufactured. Kenworth exceeds this standard and in some cases has supplied replacement parts for Kenworth trucks that were more than 25 years old.

When a Peterbilt or Kenworth customer ordered a replacement part which was not in stock at Paccar Parts or otherwise available from petitioner, or from other vendors who sold parts to petitioner, Kenworth or Peterbilt would either manufacture the part in single or small lot quantities to satisfy the customer's need or have the part built in one of their fabrication shops. Single or small run manufacture disrupted the manufacture of current production parts, involved expensive setting up of machines to manufacture the part, took from 2 to 6 weeks, and resulted in the customer receiving a part at an inflated cost and after a long wait.

Paccar Parts could not accurately project the demand for slow moving, surplus, and obsolete parts. Executives at the company knew, however, from past experience that some of the parts scrapped or disposed of as surplus and obsolete would be required to service Kenworth or Peterbilt trucks. Paccar Parts wanted to keep a lifetime supply of all usable replacement parts for Kenworth and Peterbilt trucks available, even if the parts were slow moving, surplus, or obsolete.

Paccar Parts has 64,459 part number records carried on its computer file. At least 26,666 of these are not located on any of its warehouse shelves but are available at SAJAC or from another source.

In 1976 Paccar Parts issued for use by its personnel in its inventory control and service parts organization section, a phamplet entitled "The Paccar Parts Inventory Control System." This pamphlet stated in part:

> At PACCAR Parts we use six inventory classes that are recalculated each month based on the most current 12 months of demand for the part. Thus a particular part can change its inventory class each month. The inventory classes are broken into two groups:

Inventory Class

A) B) C)	=	Stocking Parts	(Parts we hold in our warehouse for anticipated sales)
D) E) F)	=	Non-stocking Parts	(Parts we try not to have on hand in any of our warehouses)

The process we use to decide which parts will be stocking parts is explained in the section called "stocking logic."

Additionally, each letter has a specified meaning within these two big divisions. The stocking parts are divided into A, B, or C based on the forecasted annual sales and the cost of the part. To decide which class a part falls into, the computer calculates the following:

Forecast Annual Sales = (Forecast for next month × 12) × (Our unit cost)

The stocking part is then placed into one of the three categories based on the following:

If forecast annual sales is greater than $6000 = A
If forecast annual sales is between $1000 and $5999 = B
If forecast annual sales is below $1000 = C

We spend a great deal of the Planners time making sure we have the "A" items on hand. We spend relatively little time on "C" items because they will generate less than $150 a year in total sales.

The non-stocking items also have special meanings. While we try not to have these parts in stock, they do account for about 20% of our annual sales. Below is an explanation of what each of the three letters means.

Inventory Class

D = Part has been on our computer file at least one year and has not had sufficient demand in the last year to justify stocking it. It is an old part for which the demand has fallen.
E = Part that has been on the file less than one year and has not as yet accumulated enough demand to justify stocking it. It is a new part.

On April 9, 1976, Jack Lemon, the owner of SAJAC, wrote a letter to Carl Orlob, manager of material disposition at Paccar Parts. The letter stated as follows:

Thank you for your interest in our unusual service. We are a LONG TERM DORMANT WAREHOUSE that provides manufacturers with all of TAX and SPACE SAVING benefits of scrapping excess and inactive non-current inventory—yet they retain its availability for possible future sale.

We are LONG TERM because our customers have generally owned our inventory 1 to 3 years before we buy it—and we keep it another 4 to 12 years.

DORMANT WAREHOUSE describes our special low cost storage facility. Since all our inventory is obsolete, we use dense storage systems in low cost buildings that keep our warehousing costs substantially below our customers.

TAX BENEFITS vary depending whether our customer uses LIFO or FIFO, and whether the inventory is "excess" or "inactive".

SPACE SAVING because 80% of our customer's service parts inventory produces only 20% of his sales. SAJAC frees up his space for more profitable use.

Some manufacturers use our dealer parts return program. We will

* receive
* inspect and count
* sort into active and obsolete inventory
* purchase and store the obsolete—eliminating your handling
* repackage the active
* ship it to you, grouped by your warehouse locations, ready for your shelves.

During the past 6 years we have filled 150,000 Sq. Ft. of warehouses with an estimated $11 million of manufacturers inventory. We will sell only to our manufacturers, but we drop ship for them anywhere in the United States or Canada—by air or surface.

The enclosed "Dormant Inventory Proposal" describes how we purchase large quantities of inactive inventory, and sell back the few items needed for customer service each year.

* * * * * * *

SUBJECT: Dormant Inventory Proposal

We are submitting the following proposal for your consideration and acceptance, to purchase your inactive and excess inventory.

1. SAJAC will purchase mutually agreed upon inventory at a preestablished price.

2. SAJAC will transport and store their inventory in warehouses, where it will be available for resale.

3. You may purchase any portion of our inventory at the following:

   1. ____% of your current cost.
   2. ____% standard cost at time of sale to SAJAC plus an inflation factor.
   3. ____% of your selling price.

4. This agreement may be canceled by either party by notification 60 days in advance in writing. Upon cancellation, SAJAC will dispose of all their inventory.

At about the same time that Mr. Lemon made the proposal to Paccar Parts, he made similar proposals to Wagner and Dart.

Mr. Orlob arranged a meeting between Mr. Lemon and Don Luther, who was the materials manager of Paccar Parts at that time. At this meeting, Mr. Lemon explained that SAJAC was willing to "buy" Paccar Parts' obsolete parts at a scrap price figure, which was derived from a publication used by the industry, Iron Age Magazine. SAJAC proposed warehousing that inventory and holding it for a period of up to 14 years. If a part in a skid (container) of material was "resold" to Paccar Parts within 5 years, SAJAC would keep the whole skid up to 14 years. SAJAC would "sell" those parts, or whichever parts Paccar Parts needed, back to Paccar Parts at 90 percent of Paccar Parts' current production cost.

On November 8, 1976, Hank Uhthoff, who was in charge of disposition of materials at Paccar Parts, in an interoffice communication to the staff at Paccar Parts, gave the following general review of the SAJAC program:

> BACKGROUND
>
> The Sajac Company maintains long term dormant warehouses which provides manufacturers with tax and space saving benefits of scrapping excess and inactive inventory, yet retaining its availability for possible future sales.
>
> We view this proposal as a cost effective method of supplying the domestic and international aftermarket with certain fabricated and vendor parts in a timely manner to price conscious dealers. Without such a program, our customers are now faced with exceedingly long factory/vendor lead times at sometimes exorbitant prices. This program will allow us on selective items:
>
> 1. Ability to provide better service,
> 2. At a reasonable price, with
> 3. Reduced impact on our factories regarding set up costs and line interruption for one each quantities,
> 4. Flexibility of scrapping and retrieval,
> 5. Increased warehouse shelf space,
> 6. Minimized carrying costs which maximize capital opportunities, and,
> 7. Effective inventory management.
>
> SAJAC COMPANY
>
> Dormant or morgue warehousing describes Sajac's special low cost storage facility. Because all of Sajac's inventory is obsolete (aged), dense storage systems are used in low cost buildings which keeps their warehousing costs substantially below their customers.
>
> Sajac customers have generally owned their inventory one to three years before Sajac purchases it at scrap prices. Sajac maintains the material another four to twelve years.
>
> Currently, Clark Equipment, Vendo, and Addressograph Companies, to name a few, utilize Sajac's dealer direct ship program. Sajac:

> Receives and racks,
> Will cardex inventory,
> Accepts incoming orders,
> Inspects, cleans, and paints if required,
> Repackages items, and
> Ships back to us or direct to dealers using supplied labels.
>
> During the past six years, Sajac has filled over 150,000 square feet of warehouses with an estimated $11 million of manufacturer's inventory. Sajac sells only to their manufacturers and drop ships by surface or air as requested.
>
> FACILITY INSPECTION
>
> On June 16, 1976, Carol Orlob and Hank Uhthoff traveled to Beaver Dam, Wisconsin to view Sajac's office and current dormant warehouse. A modern prefab facility with 22,000 square feet of dense storage, 22 feet in height. We left Sajac satisfied beyond a doubt that they are capable of fulfilling their claims. Sajac is a well organized and structured business enterprise.
>
> SAJAC'S BENEFIT
>
> In consideration of their service, Sajac will sell back to PACCAR Parts, any of our inventory at 75% of our on-file acquisition cost, adjusted periodically by a predetermined inflation index.

On August 9, 1976, Mr. Uhthoff described pertinent parts of the SAJAC proposal to the tax manager of the corporate legal department at Paccar Parts as follows:

> In consideration of their service, Sajac will sell back to PACCAR Parts, any of our inventory at 90% of our on-file acquisition cost which will be adjusted periodically by a predetermined inflation index.
>
> * * * * * * *
>
> *Control of Material*: Contractually we cannot maintain a semblance of control and still enjoy our arms length legal consideration of "a sale". However, by agreement, Sajac will scrap material at the end of a specified time, witnessed by a PACCAR Parts employee or agent.
>
> Verbally, Sajac agrees to resell the material to us at scrap price to fulfill any future IRS disagreement of our position. * * *
>
> * * * * * * *
>
> *Sajac will not sell to anyone but PACCAR Parts. This is their current posture with existing customers. We realize that this cannot be contractually specified and still allow for an "arms length" position.*
>
> * * * * * * *

> * * * IRS regulation precludes write off of scraped material that has *not* been defaced or made unusable. It is acknowledged that we are in technical violation of this rule in our current scrap program confirmed by recent Internal Audits. However, Accounting considers our risk to be minimal and insignificant contrasted to total inventory dollar figure.
>
> [Emphasis supplied.]

Paccar Parts controlled what items were shipped to SAJAC. SAJAC never rejected any materials sent to it by Paccar Parts, Dart, or Wagner.

On December 22, 1977, in a yearend review of petitioner's arrangement with SAJAC, Mr. Uhthoff stated the following:

> During the past 14 months, the Parts Division has scrapped to SAJAC 2600 line items valued at $514,000.00—material that normally would have been defaced and scrapped after exerting all disposal alternatives.
>
> Since February 1977, we have repurchased, for firm backorders, 486 line items. Of these, 357 items or 73% were proprietary items of which 307 were emergency directs to dealers.

The following chart shows the SAJAC "purchases" and "resales" of petitioner's parts from 1976 through 1982:

	1976 through 1982		
	Total pounds purchased by SAJAC	*Total pounds repurchased by PACCAR divisions*	*Repurchase percentage*
Braden Winch Co.	122,141	4,682	3.8
Dart Truck Co.	1,250,070	391,454	31.3
PACCAR Parts	1,164,474	[3]320,692	27.5
Wagner Mining Equipment Co.	177,297	16,504	9.3
Dynacraft	243,509	None	0.0
Pacific Car & Foundry Co.	76,639	411	0.5
	3,034,130	733,743	24.2

After the promulgation of the decision of the Supreme Court in *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), SAJAC published and distributed a brochure entitled "The SAJAC System and the Internal Revenue Code." This brochure states in part:

> SAJAC Company, Inc. is in the business of purchasing and holding for resale the excess parts inventories of various manufacturers. As a purchaser of excess inventories, SAJAC provides its manufacturing customers with the opportunity to obtain the following:

---

[3] Includes 90,206 pounds repurchased by Kenworth Truck Co. division.

Relief from the financial and managerial burden of warehousing and inventorying spare parts.

A readily accessible source of replacement parts from which to service the future needs of their customers.

A tax deductible inventory loss.

In order to efficiently service the needs of its customers, a manufacturer must either maintain an inventory of replacement parts or have a readily accessible source of spare parts available. While a manufacturer might prefer to have its own inventory of parts, maintaining a complete inventory is expensive. The manufacturers' after-tax cost of maintaining such an inventory was increased significantly as a result of the 1979 United States Supreme Court decision in *Thor Power Tool Co. v. Comm.*

Prior to *Thor*, excess inventories were routinely written down by manufacturers to their net realizable value based upon management's business experience and forecasts of future demand. The tax benefits which flowed from these write-offs reduced the net cost of maintaining the inventories on hand. With the Supreme Court decision in *Thor*, however, these tax benefits are no longer available to the manufacturer who retains an inventory in excess of its immediate needs.

* * * * * * *

The Impact of Thor on Manufacturers

In light of the *Thor* decisions, manufacturers will be required to make some important decisions regarding the manner in which they will handle their excess inventories. The usual alternatives available to the manufacturer include maintaining, scrapping,[1] or selling its excess inventory. By maintaining an inventory, the manufacturer is able to provide prompt service to its customers. By scrapping the inventory, the manufacturer is able to realize significant tax benefits from inventory write-offs.

By selling the inventory to an independent firm specializing in buying excess inventory, however, the manufacturer is able to enjoy the benefits of both maintaining and scrapping the inventory while avoiding the costs associated with these alternatives.

SAJAC Offers Another Alternative

The benefits accruing to the sale of excess inventory to an independent firm such as SAJAC are significant. First, the manufacturer is relieved of the financial and managerial burden of inventorying and warehousing spare parts. Second, while the manufacturer no longer has control over the spare parts it might need in the future, these parts are still available through SAJAC at a price usually less than current market value. Finally, as a result of selling excess inventory to SAJAC at scrap metal prices, the manufacturer will have incurred a tax deductible inventory loss substantiated by an actual sale.

When a manufacturer enters into an inventory sales agreement with SAJAC, the following sequence of events occurs:

> For scrap value, SAJAC purchases and thereby obtains title and all rights to mutually agreed upon inventory.
>
> For consideration received, the manufacturer, in turn, relinquishes title and all rights to the inventory thereby sold.
>
> SAJAC stores the inventory purchased for purposes of future resale or scrapping as determined by SAJAC.
>
> The manufacturer has the right at any time to purchase from SAJAC any or all of the inventory then held by SAJAC at a price equal to approximately 90 percent of the current cost of manufacturer or purchase.

Under the terms of the purchase agreement, SAJAC is not required to retain the inventory it purchases for any specific period of time. *A sale of inventory to SAJAC pursuant to an agreement requiring SAJAC to retain the inventory for a manufacturer might not satisfy the requirements of the Regulations and Thor with regard to deductible inventory losses.* Accordingly, the inventory is retained, sold, or scrapped as SAJAC determines. It is SAJAC's policy, however, to retain the inventory it purchases for a reasonable length of time, taking into consideration the anticipated demand for such inventory.

SAJAC Satisfies Government Requirements

The Treasury Regulations permit taxpayers to write down normal inventories below market and thereby recognize a loss when the goods are offered for sale or sold at prices below market. The Supreme Court in *Thor* strictly interpreted this Regulation and held that:

> "because Thor provided no objective evidence of the reduced market value of its 'excess' inventory, its write-down was plainly inconsistent with the Regulations, and the Commissioner properly disallowed it."

A sale of inventory to SAJAC at scrap metal prices provides objective evidence of the reduced market value of a manufacturer's excess inventory. A sale to SAJAC is also a complete and closed transaction since under the terms of the purchase agreement the seller's rights to and control over the inventory absolutely expire. Accordingly, sales of excess inventory to SAJAC pursuant to SAJAC's inventory purchase agreement should satisfy the requirements of both the Regulations and the courts thereby giving rise to tax deductible inventory losses.

The SAJAC Opportunity

SAJAC has much to offer the manufacturer with inventory which exceeds its immediate needs. Upon selling its inventory to SAJAC, the manufacturer is relieved of the burden of warehousing and inventorying these excess goods. In addition, while SAJAC acquires full title and rights to the inventory it purchases, the manufacturer may repurchase this inventory or any part thereof for future use.

A sale to SAJAC at scrap metal prices provides objective evidence of the inventory's reduced market value, and is a complete and closed transaction. Accordingly, sales of excess inventory to SAJAC should satisfy the requirements of the IRS and the courts thereby affording significant tax benefits to manufacturers. Noted tax writers agree with this conclusion and have confirmed that:

> "bona fide sales to an unrelated distributor at arm's length prices should give rise to deductible tax losses."
>
> [Fn. ref. omitted; emphasis added.]

Paccar Parts had numerous potential markets for surplus and obsolete proprietary parts. The parts could either be sold through Peterbilt and Kenworth, sold as scrap to local scrap dealers, or transferred to SAJAC. In addition, obsolete parts were disposed of through the vendor return program and by means of sales to independent third parties.

A proprietary part is one that was designed and made by Kenworth or Peterbilt or was made specifically for one of their divisions. If a manufacturer designs a part specifically for sale to Kenworth or Peterbilt but also sells the part to other parties, it is classified as a vendor part by petitioner rather than a proprietary part. In order to protect their dealers from competition, Kenworth and Paccar Parts did not sell Kenworth proprietary parts to anyone except Kenworth dealers. Paccar Parts sent proprietary parts to SAJAC or to a local scrap yard but would not permit them to be used as parts by anyone but petitioner.

The corporate accounting department of petitioner, on October 28, 1977, issued an Accounting Procedure Bulletin which was numbered 27 (A.P. No. 27). This bulletin sets forth the functions and responsibilities of petitioner's employees relating to the identification, control, disposal, and reporting of obsolete and surplus inventory. Obsolete and surplus inventory are described as follows:

> 1. *Obsolescence* is defined as material that has no present or anticipated future requirements for material as a result of engineering design changes or normal market obsolescence. Obsolence guidelines are:
>
> * * * * * * *
>
> a. Production
>
> Any part (purchased or fabricated) is obsolete which has no production use. That is, either the part has been superseded or no further requirement for that part is expected.
>
> b. Service
>
> Any part is obsolete when the part has been on hand for 24 months or more and there has been no sales history for the past 24 months. If the part

has been on hand for less than 24 months, it is not considered obsolete unless due to technical obsolescence.

2. *Surplus* is defined as active material on hand in excess of normal production or service requirements.

a. Production

Material on hand is surplus when it is in excess of projected requirements for the next 24 months.

b. Service

The quantity on hand is surplus when it exceeds a *maximum* of the next 60 months' demand. This will be determined by multiplying the past 24 months' average monthly sales quantity by 60 months. If the part has been on hand less than 24 months, multiply the average monthly sales quantity for the number of months on hand by 60 months.

This procedure in no way is intended to set a policy of permitting a five-year supply for all parts. Normal service requirements, determined by prudent and efficient management, should be considerably less than the maximum of 60 months.

* * * * * * *

3. The identification and disposal of obsolete and surplus material should occur as soon as possible but prior to the next year's annual physical inventory. Some of the techniques and the suggested priority to be used in disposing of the material are as follows:

a. Sell/Transfer to other PACCAR entities
b. Return to vendor
c. Reactivate part (unless for safety reasons)
d. Rework into usable part
e. Sell to distributors/dealers/house accounts
f. Auction
g. Sell to SAJAC or similar inventory management company
h. Mutilate and scrap

Although A.P. No. 27 is dated October 28, 1977, the concepts and procedures described therein were practiced by Paccar Parts from 1975 through 1977, the years in issue in this case.

During the years here in issue and in subsequent years, petitioner sent an average of approximately 25 percent of its obsolete and surplus inventory to SAJAC. Petitioner reacquired an average of approximately 25 percent of the inventory sent to SAJAC during these years. On March 19, 1981, the administration manager at SAJAC had completed an inventory audit and requested information regarding petitioner's buy back time table for certain stored inventory. On March 23, 1981, petitioner replied that the parts were of no use to them and granted permission to scrap these parts.

On September 17, 1982, the district marketing manager of SAJAC wrote a letter to Paccar Parts requesting permission from Paccar Parts to alter or disassemble two parts that had been stored in inventory in August 1981 so these items "could be structured in a manner to be mutually profitable." On September 24, 1982, the materials disposition manager of Paccar Parts denied the request of SAJAC with the explanation that "it is against our policy to disassemble parts and take the chance of a part being mistaken for a take-off or used part."

Respondent in his notice of deficiency to petitioner determined that the losses petitioner claimed on the sales of parts inventory were not allowable with respect to parts transferred to SAJAC due to petitioner's retention of a degree of control over the use and disposition of that inventory. Respondent explained this determination as follows:

> During 1976 and 1977 certain of your operating divisions (including Paccar Parts, Dart, and Wagner Mining) entered into agreements with an unrelated firm providing for the sale of certain inventory parts. The agreements provided for the sale of the parts at the prevailing local market price for scrap materials of a like-kind, quality, and weight, but also provided that for a minimum period of 4 years, the operating divisions had the right to repurchase the parts at a price not to exceed 90% of the operating divisions' last acquisition cost, adjusted for inflation. After the expiration of the 4 year period, the unrelated entity agreed to dispose of the parts by destroying or scrapping in a commercially acceptable manner.
>
> You claimed inventory losses from such sales of inventory parts in the amounts shown below:

	1976	*1977*
Paccar Parts	$414,591	$88,580
Dart	- - -	230,800
Wagner Mining	- - -	17,103
Totals	414,591	336,483

> It is determined that you retained such a degree of control over the use and disposition of the inventory parts as to prevent the sales from being closed and completed transactions so that the claimed losses are not allowable. In addition, it is determined disallowances of such inventory losses are necessary in order to clearly reflect income. Accordingly, your income is increased $414,591 in 1976 and $336,483 in 1977.

In an amendment to answer filed October 21, 1983, respondent alleged:

(b) The allowance of the claimed losses does not clearly reflect income for 1976 and 1977 because a bona fide or arms' length sale of some or all of the petitioner's property rights in the inventory parts did not occur in those years. Furthermore, if only some of the petitioner's property rights were sold, the claimed losses were caused by the petitioner's retention of other property rights and, therefore, are not allowable.

Issue 2. Discounts to Paccint—Section 482

Paccar International, Inc. (Paccint), is a wholly owned domestic subsidiary of petitioner. Paccint was formed on September 1, 1975, and is engaged in the foreign marketing of products manufactured by petitioner's divisions. Paccint was formed by petitioner so that petitioner's international organization could handle sales of Canadian truck production while petitioner would remain eligible, through Paccar International, to take advantage of deferral benefits afforded Domestic International Sales Corporations (DISC) pursuant to sections 991 through 997 of the Code. Paccint conducts the foreign marketing by purchasing from petitioner's divisions (Kenworth, Peterbilt, Dart, and PC & F) and reselling the merchandise in the foreign market. The trucks manufactured by Kenworth were the dominant export products marketed by Paccint during the years in issue. Paccint maintains its principal place of business in Bellevue, Washington. Paccint maintained field organizations in Beirut, Paris, Eastern Europe, Johannesburg, Bogota, and Singapore, and employed specialists in these field offices to assist in marketing abroad.

Prior to September 1, 1975, petitioner conducted its foreign sales through another corporation known as Paccar International which was an operating DISC. Paccar International was a wholly owned subsidiary of petitioner. On September 1, 1975, the DISC became a wholly owned subsidiary of Paccint, and its entire staff and operations were transferred to Paccint. The DISC continued to exist solely as a paper DISC.[4]

Paccint purchased truck units and parts from the manufacturing divisions of petitioner (Kenworth, Peterbilt, Dart, and PC & F) in the amounts of $17,870,000, $59,073,000, and

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[4] When Paccar International became a subsidiary of Paccint, rather than petitioner, the sales of export property by the DISC were from Paccint to the DISC and therefore the income limitations provided for in sec. 994 were with respect to Paccint and the DISC rather than petitioner and the DISC.

$47,049,000 at dealer net prior to any discount for the period September 1, 1975, through December 31, 1975, and for the years 1976 and 1977, respectively.[5] For purchases made during the period September 1, 1975, through December 31, 1975, and the years 1976 and 1977, petitioner granted Paccint a purchase discount of 10 percent from dealer net. Dealer net is the price that a dealer pays for the product. The 10-percent discount granted to Paccint was not granted to domestic dealers. The 10-percent discount amounted to $1,786,945, $6,209,957, and $4,689,603,[6] respectively, for the period September 1, 1975, through December 31, 1975, and the years 1976 and 1977. Petitioner prepared no pricing analysis during 1975, 1976, and 1977 to support its policy of granting Paccint a 10-percent purchase discount.

In Accounting Procedure Bulletin No. 150 (A.P. No. 150), Paccint set forth the inter-company pricing of trucks. A.P. No. 150, which was revised December 1, 1975, provides in pertinent part:

> The following policies will determine intercompany pricing of trucks manufactured by one company but sold by another company. This bulletin is applicable to truck sales between the U.S. Kenworth Division/Peterbilt Motors Division, Canadian Kenworth, Kenworth Trucks Pty. Ltd., and Peterbilt of Canada. It also applies to truck sales by U.S. manufacturing companies to PACCAR International.
>
> * * * * * * *
>
> All pricing is to be in terms of the distributor net price as set out below; * * *

Products were invoiced from petitioner to Paccint at dealer net. The 10-percent discounts to Paccint were made by post-closing entries to the general ledgers of petitioner and Paccint several months after the close of the taxable year and were not reported elsewhere in the books and records of petitioner and/or Paccint. Total sales of Kenworth, Peterbilt, Dart, and PC & E for the taxable years 1975, 1976, and 1977 were $477,143,000, $734,755,000, and $1,110,027,000, respectively.

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[5] The record is somewhat confusing with respect to what is a "truck unit." In the record a "truck unit" is sometimes referred to as the truck sold by petitioner to Paccint, and at other times it is used to refer to the truck plus allied equipment sold by Paccint to its foreign customers. However, since the record is clear that Paccint did not buy allied equipment from petitioner, reference to "truck unit" as used herein with respect to purchases and sales by Paccint refers only to the trucks bought by Paccint from petitioner. When referring to the trucks plus allied equipment in connection with purchases and sales by Paccint, the reference will be to "truck and allied equipment."

[6] Note that these figures represent a little less than 10 percent for the last 4 months of 1975 and a little more than 10 percent for the years 1976 and 1977.

The equipment that Paccint sold in the foreign market included allied equipment which is designed to operate in conjunction with petitioner's trucks as an integrated operating unit and is attached to and built onto a truck unit. Allied equipment was only offered for sale in conjunction with a truck unit. For example, the trailer portion of a van trailer is allied equipment. Allied equipment was bought by Paccint directly from independent manufacturers and not from petitioner. When Paccint would receive an inquiry from a foreign dealer or other foreign customer for a truck for a specific purpose, personnel in its Bellevue, Washington, office would contact petitioner with respect to the specifications for the truck, to determine if the specifications could be met, and the price of the truck. If the truck could be supplied by one of petitioner's divisions, someone in Paccint's Bellevue, Washington, office would contact a builder of allied equipment to be used with the truck to obtain the cost of the allied equipment specified for the truck. If the sale was consummated, when the manufacture of the truck was completed, it would be sent to the manufacturer of the allied equipment, and the truck and allied equipment would be combined and shipped on behalf of Paccint overseas. Paccint would be billed for the allied equipment directly by the unrelated manufacturer of the allied equipment.

The records of Paccint of sales and costs of allied equipment were kept separate from its sales and costs of trucks and parts bought from petitioner. For the period September 1, 1975, through December 31, 1975, and the years 1976 and 1977, Paccint had the following sales of and profit margins on allied equipment:

Year	*Sales*	*Margin*	*Margin as percent of sales*
Sept. 1, 1975— Dec. 31, 1975	$5,794,000	$1,106,000	19.0
1976	12,425,000	2,201,000	17.7
1977	7,707,000	1,226,000	15.9

Parts are sold at a different time and in a different transaction from the sales of the truck units. Paccint purchases its parts from petitioner and is allowed a 10-percent discount on parts.

Petitioner's manufacturing divisions incur the following expenses:

(1) Costs applied (manufacturing costs).
(2) Engineering expense.
(3) Field service expense.
(4) Selling expense.
(5) Parts overhead.
(6) Division administrative expense.
(7) Corporate administrative expense.
(8) Repossession and bad debt expense.

On sales to Paccint as compared to sales to domestic dealers, petitioner incurred less field service expense, selling expense, parts overhead, and repossession and bad debt expense. Petitioner was also relieved of certain expenses associated with selling on the foreign market. The cost of foreign marketing generally exceeds the selling expenses on the domestic market. Although the sales from petitioner to Paccint were domestic sales, Paccint was responsible for marketing the products abroad and maintained a staff of professionals abroad to assist in marketing. The significant differences between selling in the domestic market and selling in a foreign market include the following:

(1) Terms of payment.
(2) Means of protecting risks.
(3) Liens more secure in United States.
(4) Collections more difficult abroad.
(5) Difficult access to legal systems abroad.

There was no direct saving to petitioner of general and administrative expenses as a result of the sales to Paccint. The administrative expenses associated with petitioner's business are typically fixed costs over a wide range of activities and would be affected only slightly, if at all, by the relatively small percentage of sales to Paccint. Interest expense on inventory is proportionately greater for petitioner on sales to Paccint than it is on sales to domestic dealers.

Kenworth, Peterbilt, Dart, and PC & F had total expenses in the years 1975, 1976, and 1977 for field service, selling, parts overhead, repossession, and bad debts of $17,347,000, $21,809,000, and $30,091,000, respectively.

For the period September 1, 1975, through December 31, 1975, and the years 1976 and 1977, Paccint had sales of truck units in the amounts of $18,483,000, $51,662,000, and $34,759,000, respectively. The sales expenses associated with petitioner's sales to Paccint are the same as they would be to domestic dealers.

For the period September 1, 1975, through December 31, 1975, Paccint had sales of parts in the amount of $2,178,000 and a margin of $80,000 based on cost before reduction by the 10-percent discount. For the taxable year 1976, Paccint had sales of parts in the amount of $16,304,000, and a similar margin of $104,000. For the taxable year 1977, Paccint had sales of parts in the amount of $16,750,000, and a similar margin of $204,000.

Parts are sold by Paccint only when the need for a replacement part arises. Paccint also accounts for the sale of parts in a different fashion than the sales of truck units and allied equipment. Upon the sale of a truck unit, Paccint directly invoices the customer. When parts are sold by Paccint, the invoice to the customer is issued by Paccar Parts.

In his notice of deficiency issued to petitioner, respondent determined under section 482 that the 10-percent price discounts petitioner granted to its wholly owned subsidiary, Paccint, are not allowable, giving the following explanation:

> During 1975, 1976 and 1977 various manufacturing divisions of Paccar, Inc., (including Kenworth Truck Company, Peterbilt Motors Company, Dart Truck Company and Pacific Car and Foundry Company) sold certain products and parts to Paccar International, Inc. (hereinafter "Paccint"), a wholly owned subsidiary of Paccar, Inc. Such products and parts were ultimately destined for export markets and at the end of each yearly accounting period a ten (10) percent price discount was allowed. Paccar, Inc., Paccint, and various other controlled corporations reported their incomes in consolidated returns, forms 1120, for such years.
>
> Paccint reflected in its reported incomes for such years certain deemed dividend distributions as well as deductions with respect to its wholly owned subsidiary, Paccar (International) Inc., a qualified domestic international sales corporation (DISC).
>
> Under section 482 of the Internal Revenue Code, it is determined the ten percent price discounts granted by Paccar, Inc., to Paccint are not allowable

because such discounts result in evasion of taxes or do not clearly reflect the income of such corporations. Disallowance of such discounts has a causal effect on the deemed dividend distributions and the deductions reported by Paccint inasmuch as such items are dependent in part upon Paccint's and Paccar (International), Inc.'s combined taxable incomes pursuant to sections 991-995 of the Internal Revenue Code.

The determined discount disallowances result in the following adjustments to consolidated taxable income:

	1976	*1977*
Deemed dividend distribution		
Per return	$3,012,175	$5,114,549
Per exhibit A	2,365,113	3,309,987
Adjustment	(647,062)	(1,804,562)

	1975	*1976*	*1977*
DISC commissions			
Per return	$2,154,626	$5,902,532	$2,508,842
Per exhibit B	1,256,437	2,955,911	0
Adjustment	898,189	2,946,621	2,508,842
Other uncontested DISC allocation adjustments	23,051	150,343	(316,619)
Net adjustment	921,240	3,096,964	2,192,223

OPINION

Issue 1. Transfer of Parts Inventory to SAJAC

Respondent takes the position that petitioner is not entitled to reduce its inventories in the years 1976 and 1977 by the loss it showed on sales of parts inventory to SAJAC. Respondent contends that in substance, no sale occurred because the benefits and burdens of ownership were never transferred by petitioner to SAJAC.[7] Respondent argues that SAJAC assumed the burden of storing and caring for the inventory and thus its role resembled that of a storage agent while Paccar retained the benefits of the ownership of the inventory. Respondent contends further that the transactions were put in the form of sales solely for tax-avoidance purposes and in reality a storage agency relationship rather than a buyer-seller relationship was created between petitioner and SAJAC. Respondent argues that petitioner retained such a degree of control over the use and disposition of the inventory parts that the purported "sales" could not be classified as closed and completed transactions. According to respondent, the contracts petitioner entered into with SAJAC purport to transfer title, ownership, and risk of loss when in fact petitioner retained all substantial rights of ownership and merely sent slower moving or excess parts to SAJAC for storage.

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[7] See Rev. Rul. 83-59, 1983-1 C.B. 103.

Petitioner asserts that its transactions with SAJAC constituted bona fide sales and that its retention of rights to the parts inventory amounted to, at most, an option to repurchase at a premium price.

In support of its position, that it "sold" the inventory to SAJAC, petitioner points to specific language in the contract between the parties. Petitioner emphasizes the use of the words "sell," "repurchase," and "selling price." Petitioner points to the language in the second paragraph of the contract, which states: "Title to, property in and ownership of all scrap material shall pass to SAJAC upon delivery * * *. All goods are sold F.O.B. seller's warehouse, and all risk of loss shall be borne by SAJAC" to emphasize the parties' characterization of the transaction as a sale.

It is well settled that the economic substance of the transaction, rather than its form will govern in determining whether a transaction is a bona fide sale for income tax purposes. *Gregory v. Helvering,* 293 U.S. 465 (1935); *Grodt & McKay Realty, Inc. v. Commissioner,* 77 T.C. 1221, 1236 (1981). The Supreme Court in *Frank Lyon Co. v. United States,* 435 U.S. 561, 573 (1978), has clearly set forth the principles to be followed in deciding this issue:

> This Court, almost 50 years ago, observed that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss v. Bowers,* 281 U.S. 376, 378 [50 S. Ct. 336, 74 L. Ed. 916] (1930). In a number of cases, the Court has refused to permit the transfer of formal legal title to shift the incidence of taxation attributable to ownership of property where the transferor continues to retain significant control over the property transferred. E.g., *Commissioner of Internal Revenue v. Sunnen,* 333 U.S. 591 [68 S. Ct. 715, 92 L. Ed. 898] (1948); *Helvering v. Clifford,* 309 U.S. 331 [60 S. Ct. 554, 84 L. Ed. 788] (1940). In applying this doctrine of substance over form, the Court has looked to the objective economic realities of a transaction rather than to the particular form the parties employed. The

> Court has never regarded "the simple expedient of drawing up papers," *Commissioner of Internal Revenue v. Tower*, 327 U.S. 280, 291 [66 S. Ct. 532, 538, 90 L. Ed. 670] (1946), as controlling for tax purposes when the objective economic realities are to the contrary. "In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal written documents are not rigidly binding." *Helvering v. Lazarus & Co.*, 308 U.S. at 255 [60 S. Ct. at 210]. See also *Commissioner of Internal Revenue v. P. G. Lake, Inc.*, 356 U.S. 260, 266–267 [78 S. Ct. 691, 2 L. Ed.2d 743] (1958); *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331, 334 [65 S. Ct. 707, 89 L. Ed. 981] (1945). Nor is the parties' desire to achieve a particular tax result necessarily relevant. *Commissioner of Internal Revenue v. Duberstein*, 363 U.S. 278, 286 [80 S. Ct. 1190, 4 L. Ed.2d 1218] (1960). [435 U.S. at 572–573.]

The question of whether a sale has occurred for purposes of Federal income taxation requires an examination of whether the benefits and burdens of ownership have been transferred. *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. at 1237. This determination is essentially one of fact and is ascertained from the intention of the parties as evidenced by the written agreements read in light of the attendant facts and circumstances. 77 T.C. at 1237; *Derr v. Commissioner*, 77 T.C. 708, 724 (1981); *Baird v. Commissioner*, 68 T.C. 115, 124 (1977); *Deyoe v. Commissioner*, 66 T.C. 904, 910 (1976). It is now well established that the economic substance of a transaction, rather than its form, controls for Federal tax purposes. *Gregory v. Helvering*, 293 U.S. 465 (1935); *Derr v. Commissioner, supra* at 722. The "labels, semantic technicalities, and formal written documents do not necessarily control the tax consequences of a given transaction. Rather, we are concerned with economic realities and not the form employed by the parties." *Houchins v. Commissioner*, 79 T.C. 570, 589 (1982); see also *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Estate of Franklin v. Commissioner*, 64 T.C. 752 (1975), affd. on other grounds 544 F.2d 1045 (9th Cir. 1976).

Petitioner argues that the cases of *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970), and *Union Planters National Bank of Memphis v. United States*, 426 F.2d 115 (6th Cir. 1970), relied on by respondent, upon close analysis support its position. However, in our view these cases do not support the conclusion advanced by petitioner. In *American National Bank of Austin* and *Union Planters National Bank of Memphis*, the Fifth and Sixth Circuits respectively concluded that "sale and repurchase" transactions involving municipal bonds were in substance loans by the bank to bond dealers on the security of the bonds rather than purchases of the bonds by the bank due to the continued dominion exercised by the purported seller prior to its "repurchase" of the bonds. The Fifth Circuit, in *American National Bank of Austin*,[8] decided that a bank which paid an issuing authority for municipal bonds awarded to dealers who subsequently sold the bonds to their customers was not, for tax purposes, to be considered the owner of the bonds. The court stated that "Only persons having the rights and incurring the risks that ownership of municipal bonds entails may" be considered the owner. 421 F.2d at 451. The court concluded that the "taxpayer's 'ownership' of these bonds was without substance" (451 F.2d at 453), because the purported seller "exercised complete dominion over the bonds after they came into the [buyer's] possession." 421 F.2d at 452. The seller "sold them at his pleasure, at prices he determined, and without reference to the bank * * *. Obviously the inventory of bonds was being held by the bank for the dealers and subject to their disposition." 421 F.2d at 452. The court concluded that a sale did not take place because the basic risk of ownership of the bonds was retained by the transferors. The facts in *Union Planters National Bank of Memphis* were identical to those in *American National Bank of Austin*, except that in that case there were written repurchase agreements under which the bank could require the dealer to repurchase at any time at a price which would guarantee the bank against any loss. In *Austin*, the dealers had only an unwritten option to repurchase and there was no written contract as there was in the case involving the Memphis bank. The Sixth Circuit found that the transaction between the bank and the bond dealers in *Union Planters*, "although characterized as sales-repurchases by the parties, will be regarded as secured loans for federal income tax purposes." 426 F.2d at 118. When a dealer found a customer for the bonds, he would repurchase them from the bank which never refused to resell the bonds although, under the written repurchase agreement, it was not bound to do so.

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[8] The United States Court of Claims (now the United States Court of Appeals for the Federal Circuit) in 1978 in *American National Bank of Austin v. United States*, 216 Ct. Cl. 92, 573 F.2d 1201 (1978), held that for the years before it (1965 to 1970), the taxpayer was not collaterally estopped by the decision of the Fifth Circuit in *American National Bank of Austin v. United States*, 421 F.2d 442 (5th Cir. 1970), which involved the years 1962 to 1964, to contend that the transactions were in fact sales and repurchases. After the decision of the Fifth Circuit in 1970, the board of directors of the bank informed all bond dealers in the area that it was terminating the business of "taking up" bond issues at the request of successful bidder-dealers, and that all existing options to acquire from the bank must be exercised on or before May 1, 1970, or would terminate. After receiving this notice, all bond dealers except six exercised their options to acquire from the bank all bonds for which the then-existing market prices were in excess of the option prices. The six bond dealers who failed to exercise their option refused to do so even after the bank requested them to do so. The bank subsequently sustained a loss of more than $160,000 on one group of these bonds. Based on these facts, the Court of Claims concluded that the bank had purchased these bonds subject to options by the dealers to acquire the bonds subsequently from the bank. The court concluded that the bank actually bore the "basic risk of ownership of a bond" during the years 1965 to 1970, and that the Fifth Circuit had dealt with a different set of circumstances for tax years 1962 to 1964. The Court of Claims stated:

> "The two companion cases now before this court not only involve taxable years different from those that were involved in the earlier *American National Bank of Austin* case, and involve transactions between the plaintiff and bond dealers different from the transactions that were involved in the earlier case, but we have here an additional circumstance of considerable significance that did not appear in the earlier case.
>
> "The evidence in the earlier *American National Bank of Austin* case showed that during the years involved in that case (1962–1964), no successful bidder-dealer, at whose request the plaintiff had paid an issuing authority for a bond issue, subsequently failed to acquire the bonds from the plaintiff. * * *
>
> "Thus, it was the supposed lack of risk on the part of the plaintiff that led the Court of Appeals in the first *American National Bank of Austin* case to conclude that, in substance, the transactions between the plaintiff and successful bidder-dealers during the 1962–64 period were loan transactions. On the other hand, the evidence in our present record shows that, when the crunch finally came and the matter was put to the test, the plaintiff actually bore the 'basic risk of ownership of the bonds.' According to the evidence in this record, six bond dealers declined to exercise their options, the plaintiff had no legal recourse against them, and, as a consequence, the plaintiff sustained a large financial loss.
>
> "It is concluded, therefore, that the doctrine of collateral estoppel is not applicable to the present litigation, that the decision of the Court of Appeals in the first *American National Bank of Austin* case should not control the outcome of the present cases, and that the transactions between the plaintiff and successful bidder-dealers during the 1965–70 period involved, in substance as well as in form, purchases of municipal bonds by the plaintiff, subject to options on the part of the bond dealers to acquire the bonds from the plaintiff."
>
> [573 F.2d at 1206–1207. Fn. ref. omitted.]

In our view, the following four factors should be considered in determining the character of the transactions between petitioner and SAJAC: (1) Who determined what items were taken into inventory; (2) who determined when to scrap existing inventory; (3) who determined when to sell inventory; and (4) who decided whether to alter inventory. See *Grodt & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237–1238 (1981).

(1) *What items taken into inventory.*—SAJAC exercised no discretion over what it accepted into inventory and therefore accepted even worthless inventory. If SAJAC intended to be the owner of this inventory, it would have shown some interest in the quality of goods it was purchasing. On the contrary, petitioner was solely responsible for which items in inventory

were transferred to SAJAC. In fact, the record reflects that SAJAC never refused a shipment of parts from any of petitioner's divisions. Thus, with respect to this element we conclude that petitioner behaved as if SAJAC was merely warehousing the inventory for petitioner's future use.

(2) *Scrapping inventory.*—The record reflects that petitioner made all decisions concerning when to scrap the inventory stored at SAJAC. If SAJAC had been the owner of this inventory, it would have been more interested in making this key determination. Even after the expiration of the minimum 4-year period as specified in paragraphs 4 and 6 of the agreement between petitioner and SAJAC, petitioner continued to make the decisions regarding scrapping of inventory. In fact, the parties had tacitly agreed that SAJAC would take no unilateral action regarding scrapping the inventory parts stored at SAJAC. Pursuant to the terms of the agreement, after a period of 4 years, SAJAC went to petitioner to ask permission to scrap the inventory if petitioner had purchased no material from a particular container housing inventory. Petitioner would then decide whether or not the material should be scrapped or saved. Thus, we conclude that in deciding whether to scrap materials held in inventory, petitioner behaved as if it remained the owner of the inventory and as if SAJAC was merely a storage agent.

(3) *When to sell.*—Pursuant to paragraph four of the contract between petitioner and SAJAC, SAJAC is denied the rights to sell the parts in its warehouse to anyone but petitioner for a period of 4 years. In addition, SAJAC is restricted from selling the parts as anything other than scrap once the 4 years have expired. In short, SAJAC is permitted to sell only after petitioner has sanctioned such a sale. It is clearly established that one of the indicia of ownership is the right to dispose of property. We conclude therefore that SAJAC's inability to sell the parts without petitioner's permission leads to the conclusion that petitioner retained the ownership rights in the inventory transferred to SAJAC.

(4) *Alteration of inventory.*—The record reflects that the marketing manager of SAJAC requested permission from petitioner to disassemble or alter items contained in inventory at SAJAC. The marketing manager suggested that such disassembly or alteration might be mutually profitable for SAJAC and

petitioner. Petitioner refused to grant permission for the suggested disassembly or alteration. In our view, the fact that SAJAC even requested such permission indicates that petitioner retained ownership rights in the inventory and that SAJAC was merely a storage facility.

In the instant case, we conclude that the transaction between petitioner and SAJAC did not constitute a sale because petitioner retained dominion and control over the assets transferred to SAJAC for at least 4 years after the initial transfer. During this period, SAJAC was required to retain the inventory transferred. As a matter of practice, the inventory was retained for a longer time. Not only was SAJAC unable to dispose of the assets for at least 4 years but, even after that period expired, when SAJAC requested permission from petitioner to sell the inventory it was not permitted to sell it in usable form. Petitioner also retained the right to require SAJAC to destroy, scrap, dismantle, or mutilate the material not resold to petitioner. In effect, petitioner retains the same control over the inventory that it had before shipping it to SAJAC. The only right SAJAC had with respect to the inventory was to receive an agreed amount for any item petitioner had shipped to a dealer for use as a part. In effect, this payment was no more than a flexible storage fee. Despite the priorities of inventory disposition set forth in A.P. No. 27 which listed selling to SAJAC as a seventh option, the record reflects that petitioner sent inventory to SAJAC as a matter of course in order to retain the parts for future shipment to dealers, but at the same time, to attempt to achieve tax benefits as if the inventory had been sold.

In *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522 (1979), affg. 563 F.2d 861 (7th Cir. 1977), affg. 64 T.C. 154 (1975), the taxpayer wrote down its excess inventory to an amount it estimated to be its net realizable value which in most cases was scrap value. This Court had found that the taxpayer's actions were in accord with generally accepted accounting principles and therefore in compliance with the best accounting practice in the business. This finding was not challenged, leaving only the issue for the Supreme Court's determination of whether the taxpayer's inventory value clearly reflected income as is also required by section 471. The Supreme Court recognized that Thor valued its inventory at the "lower of cost or market" which is an acceptable and normal method of inventory valuation. The Court pointed out that "market" as defined in section 1.471–4(a), Income Tax Regs., is "the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer." The Court then discussed the two exceptions to this definition, the first being where the taxpayer has actually offered merchandise for sale at prices lower than replacement cost (sec. 1.471–4(b), Income Tax Regs.), and the second, where the goods are unsalable at normal prices or unsalable in the normal way because of damage (sec. 1.471–2(c), Income Tax Regs.). In *Thor*, the Supreme Court concluded that the taxpayer had offered no objective evidence to verify its estimate of reduced market value. Despite the lower inventory value, the taxpayer retained the items in inventory and continued to hold the goods for sale at original prices. Therefore, the Court held that the taxpayer did not comply with the regulations. Under the holding of the Supreme Court in the *Thor* case, petitioner in this case would not have been justified in writing down its parts inventory which it continued to hold for sale at the original prices.

In our view, the transfer of excess and obsolete inventory from petitioner to SAJAC did not constitute a sale but was a device designed to circumvent our holding in *Thor Power Tool Co. v. Commissioner, supra*, which was affirmed by the Supreme Court.[9] Petitioner was faced with several options. If the excess inventory was carried at its cost on petitioner's books, the amount it would ultimately receive for the inventory would probably be overstated since many of the items would not be sold. If the inventory were scrapped prematurely, it would cost petitioner considerably more than the normal manufacturing cost to reproduce a specifically needed part for petitioner's customers. Petitioner "sold" the inventory to SAJAC and wrote down the value of its inventory in an effort to decrease taxable income by claiming a loss on its return while still having the inventory available when needed. As the Supreme Court stated—

> The taxpayer thus sees itself presented with "an unattractive Hobson's choice: either the unsalable inventory must be carried for years at its cost

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[9] Our opinion in *Thor Power Tool Co. v. Commissioner*, 64 T.C. 154, was filed May 16, 1975.

> instead of net realizable value, thereby overstating taxable income by such overvaluation until it is scrapped, or the excess inventory must be scrapped prematurely to the detriment of the manufacturer and its customers." * * *
>
> If this is indeed the dilemma that confronts Thor, it is in reality the same choice that every taxpayer who has a paper loss must face. It can realize its loss now and garner its tax benefit, or it can defer realization, and its deduction, hoping for better luck later. Thor, quite simply, has suffered no present loss. It deliberately manufactured its "excess" spare parts because it judged that the marginal cost of unsalable inventory would be lower than the cost of retooling machinery should demand surpass expectations. This was a rational business judgment and, not unpredictably, Thor now has inventory it believes it cannot sell. Thor, of course, is not so confident of its prediction as to be willing to scrap the "excess" parts now; it wants to keep them on hand, just in case. This, too, is a rational judgment, but there is no reason why the Treasury should subsidize Thor's hedging of its bets. There is also no reason why Thor should be entitled, for tax purposes, to have its cake and to eat it too.
>
> [*Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 545–546 (1979).]

In our view, petitioner's thinly veiled subterfuge of a "sale" to SAJAC does not distinguish its situation from that present in the *Thor* case. In substance, petitioner did not sell its inventory to SAJAC.

Petitioner further contends, apparently in the alternative, that a write-down of its inventory is supported by the holding in *St. James Sugar Co-op, Inc. v. United States*, 643 F.2d 1219 (5th Cir. 1981). In that case, the Fifth Circuit upheld the taxpayer's valuation of its inventory on the basis that market did not exceed net realizable value based on the taxpayer's estimate of the inventory's value in the declining market. Following *Space Controls, Inc. v. Commissioner*, 322 F.2d 144 (5th Cir. 1963), revg. and remanding a Memorandum Opinion of this Court, the Circuit Court upheld the write-down of the taxpayer's inventory to net realizable value based upon section 1.471–4(b), Income Tax Regs. The Court held that St. James Sugar Co-op's valuation was reasonable under the volatile conditions of the sugar market which indicated a decline in market prices. In *Space Controls*, the taxpayer was obligated under a fixed price contract with the Government to manufacture trucks which could not be used by anyone else. Although a bid price was available, the write-down was upheld by the Circuit Court on the basis that the contract constituted a sale in the regular course of business, and the price fixed by the contract was less than the current bid price. In the *St. James*

Sugar Co-op case, the Fifth Circuit distinguished *Thor* on the basis that *St. James Sugar Co-op* had produced sufficient objective evidence of the reduced value for the inventory. The facts in *St. James Sugar Co-op* differ markedly from those in the instant case. The taxpayer in *St. James Sugar Co-op* had contracted to sell its complete inventory and therefore could not sell it on the open market. Thus, the value *St. James Sugar Co-op* placed upon its inventory was supported by an objective estimate of the inventory's net realizable value. This valuation is sanctioned within the guidelines of sections 1.471–4(b)[10] and 1.471–2(c),[11] Income Tax Regs., which allow inventories to be reduced under limited circumstances to an objective estimate of the net realizable value.

In the instant case, petitioner does not fall within the guidelines of sections 1.471–4(b) and 1.471–2(c), Income Tax Regs. Since petitioner did not in substance sell its inventory to SAJAC but retained control over it, in effect, petitioner here as in *Thor* is attempting to write down its inventory while still controlling it. Under the holding in *Thor*, this is not permissible.

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[10] Sec. 1.471–4(b), Income Tax Regs., provides as follows:

(b) Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

[11] Sec. 1.471–2(c), Income Tax Regs., provides as follows:

(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see sec. 1.471–5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

On the basis of this record, we sustain respondent's disallowance of petitioner's claimed "loss on sale of inventory" to SAJAC.

Issue 2. Discounts to Paccint—Section 482

The second issue for decision is whether respondent correctly determined under section 482[12] that the 10-percent discounts granted by petitioner to Paccint for the taxable years 1975, 1976, and 1977 should be disallowed.

Respondent contends that the 10-percent discounts granted by petitioner to Paccint represent an impermissible allocation of income from petitioner to Paccint. Respondent's position is that petitioner's sole objective in granting the 10-percent discount was to secure increased DISC deferral benefits that would have otherwise been unavailable to petitioner after the interposition of Paccint between petitioner and the DISC, Paccar International, on September 1, 1975.

Respondent takes the position that by granting 10-percent discounts to Paccint, petitioner was attempting to avoid taxes by shifting to Paccint a larger profit than would otherwise have been available with a resultant larger DISC deferral under the 50-percent combined income method provided for in section 994(a).

After the interposition of Paccint between petitioner and the DISC, petitioner no longer qualified as a "related supplier" of the DISC because it did not engage directly in a transaction with the DISC. See sec. 1.994-1(a)(3)(ii), Income Tax Regs.

After the formation of Paccint, the DISC allocation was based on the profits earned by Paccint since petitioner was no longer a "related supplier" of the DISC. To increase the profits earned by Paccint, petitioner, on sales to Paccint, granted a 10-percent discount from domestic dealer net. After September 1, 1975, the DISC continued to operate solely as a paper DISC which was a wholly owned subsidiary of Paccint.[13]

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[12] Sec. 482 provides as follows:

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

Petitioner argues that the 10-percent discount was justified because of expenses borne by Paccint and that it was not granted to evade taxes. Petitioner contends that granting this discount does clearly reflect income.

There is no question that petitioner "controlled" Paccint within the meaning of section 482. In our view, the record is clear that petitioner granted the 10-percent discount to Paccint in order to increase Paccint's income which would result in increasing the DISC deferral and reduce the taxes paid by petitioner and its subsidiaries on a consolidated basis. Respondent was therefore justified under section 482 in adjusting the prices charged by petitioner to Paccint if the prices with the 10-percent discount do not clearly reflect petitioner's income.

Petitioner argues that the allowance of the 10-percent discount does clearly reflect income of Paccint and petitioner.

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[13] After Paccint was interposed between petitioner and the DISC, petitioner's corporate tax manager prepared the following chart which in his opinion contrasts tax consequences resulting from the interposition of Paccint between petitioner and the DISC and the tax benefits the DISC had enjoyed prior to the interposition:

Tax Disadvantage of Not Using an Operating DISC

	9/75 – 12/75	*1976*	*1977*	*Total*
Income had DISC been an "Operating DISC"	$3,696,000	$8,628,000	$5,475,000	$17,799,000
Actual income "Paper DISC"	(2,401,000)	(6,093,000)	(2,998,000)	(11,492,000)
Difference	1,295,000	2,535,000	2,477,000	6,307,000
Dividend to parent	(648,000)	(1,597,000)	(1,598,000)	(3,843,000)
Decrease in DISC deferral	647,000	938,000	879,000	2,464,000
Tax rate	×.48	×.48	×.48	×.48
Tax disadvantage of "Paper DISC"	310,560	450,240	421,920	1,182,720

Petitioner's corporate tax manager also prepared a chart which in his opinion illustrated the effect on Paccint's income of not giving the 10-percent discount to Paccint:

Income From Operations Had There Been
No 10-Percent Discount on Products
Purchased From Paccar, Inc.

1975	$2,755,143
1976	6,130,390
1977	(717,933)
1978	203,650
1979	(5,300,458)
1980	(3,967,845)
1981	(3,957,629)
1982	(2,746,729)
1983	(2,954,547)
Income (losses) 1975-1983	(10,555,958)

Petitioner states that the savings realized as a result of Paccint's assuming petitioner's wholesaling function can be properly measured by determining expenses incurred by Paccint in the export marketing of petitioner's products and an adjustment for this savings results in a comparable uncontrolled price under section 1.482-2(e)(2), Income Tax Regs.

Section 482 gives respondent broad authority to allocate gross income, deductions, credits, or allowances between commonly controlled organizations if he determines that such allocation is necessary either to prevent the evasion of taxes or in order to clearly reflect the income of such corporations. For a discussion of the history and purpose of section 482, see *Eli Lilly & Co. v. Commissioner*, 84 T.C. 996, 1115–1116 (1985); *Foster v. Commissioner*, 80 T.C. 34, 191–195 (1983), affd. in part and vacated in part on another issue 756 F.2d 1430 (9th Cir. 1985). The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled, unrelated taxpayer, by determining according to the standard of an uncontrolled taxpayer, the true taxable income of the controlled taxpayer. *Ciba-Geigy Corp. v. Commissioner*, 85 T.C. 172, 221 (1985); *Huber Homes, Inc. v. Commissioner*, 55 T.C. 598, 605 (1971); sec. 1.482-1(b)(1), Income Tax Regs. The standard we must apply is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Sec. 1.482-1(b)(1), Income Tax Regs.

Respondent's determination as set forth in the notice of deficiency is presumptively correct and the burden of disproving that determination lies with petitioner. Rule 142(a), Tax Court Rules of Practice and Procedure; *Welch v. Helvering*, 290 U.S. 111 (1933). Respondent also has broad discretion in his application of section 482. *Ciba-Geigy Corp. v. Commissioner, supra*; *Eli Lilly & Co. v. Commissioner, supra*; *Spicer Theatre, Inc. v. Commissioner*, 346 F.2d 704, 706 (6th Cir. 1965), affg. 44 T.C. 198 (1964). Respondent's determination will be upheld unless petitioner proves it to be arbitrary, capricious, or unreasonable. See, e.g., *Eli Lilly & Co. v. Commissioner, supra*; *Phillip Brothers Chemicals, Inc. (N.Y.) v. Commissioner*, 435 F.2d 53, 57 (2d Cir. 1970), affg. 52 T.C. 240 (1969); *Ach v. Commissioner*, 42 T.C. 114, 125–126 (1964), affd. 358 F.2d 342 (6th Cir. 1966). Whether or not respondent has exceeded or abused his discretion turns upon questions of fact. *American*

Terrazzo Strip Co. v. Commissioner, 56 T.C. 961, 971 (1971); *Ballentine Motor Co. v. Commissioner*, 321 F.2d 796, 800 (4th Cir. 1963), affg. 39 T.C. 348 (1962).

Section 1.482-2(e), Income Tax Regs.,[14] provides that when one member of a controlled group sells property to another member of that group at other than an arm's-length price, an appropriate allocation may be made to reflect an arm's-length transaction. An arm's-length price is the price an unrelated party would have paid. Section 1.482-2(e)(2)(3) and (4) describes three methods of determining an arm's-length price. The first of these methods is the comparable uncontrolled price method.[15]

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[14] Sec. 1.482-2(e), Income Tax Regs., provides as follows:

(e) *Sales of tangible property*—(1) *In general.* (i) Where one member of a group of controlled entities (referred to in this paragraph as the "seller") sells or otherwise disposes of tangible property to another member of such group (referred to in this paragraph as the "buyer") at other than an arm's length price (such a sale being referred to in this paragraph as a "controlled sale"), the district director may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

[15] Sec. 1.482-2(e)(2), Income Tax Regs., provides as follows:

(2) *Comparable uncontrolled price method.* (i) Under the method of pricing described as the "comparable uncontrolled price method", the arm's length price of a controlled sale is equal to the price paid in comparable uncontrolled sales, adjusted as provided in subdivision (ii) of this subparagraph.

(ii) "Uncontrolled sales" are sales in which the seller and the buyer are not members of the same controlled group. These include (a) sales made by a member of the controlled group to an unrelated party, (b) sales made to a member of the controlled group by an unrelated party, and (c) sales made in which the parties are not members of the controlled group and are not related to each other. However, uncontrolled sales do not include sales at unrealistic prices, as for example where a member makes uncontrolled sales in small quantities at a price designed to justify a nonarm's length price on a large volume of controlled sales. Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. If the differences can be reflected by such adjustment, then the price of the uncontrolled sale as adjusted constitutes the comparable uncontrolled sale price. Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparble, depends upon the particular circumstances and property involved. The principles of this subdivision may be illustrated by the following examples, in each of which it is assumed that X makes both controlled and uncontrolled sales of the identical property: [Examples omitted.]

The other two methods are the resale price method,[16] and the cost plus method. Sec. 1.482-2(e)(1)(ii), Income Tax Regs. A fourth method is provided for by the following language in section 1.482-2(e)(1)(iii), Income Tax Regs.:

> (iii) Where the standards for applying one of the three methods of pricing described in subdivision (ii) of this subparagraph are met, such method must, for the purposes of this paragraph, be utilized unless the taxpayer can establish that, considering all the facts and circumstances, some method of pricing other than those described in subdivision (ii) of this subparagraph is clearly more appropriate. Where none of the three methods of pricing described in subdivision (ii) of this subparagraph can reasonably be applied under the facts and circumstances as they exist in a particular case, some appropriate method of pricing other than those described in subdivision (ii) of this subparagraph, or variations on such methods, can be used.

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[16] Sec. 1.482-2(e)(3), Income Tax Regs., provides as follows:

(3) *Resale price method.* (i) Under the pricing method described as the "resale price method", the arm's length price of a controlled sale is equal to the applicable resale price (as defined in subdivision (iv) or (v) of this subparagraph), reduced by an appropriate markup, and adjusted as provided in subdivision (ix) of this subparagraph. An appropriate markup is computed by multiplying the applicable resale price by the appropriate markup percentage as defined in subdivision (vi) of this subparagraph. Thus, where one member of a group of controlled entities sell property to another member which resells the property in uncontrolled sales, if the applicable resale price of the property involved in the uncontrolled sale is $100 and the appropriate markup percentage for resales by the buyer is 20 percent, the arm's length price of the controlled sale is $80 ($100 minus 20 percent × $100), adjusted as provided in subdivision (ix) of this subparagraph.

(ii) The resale price method must be used to compute an arm's length price of a controlled sale if all the following circumstances exist:

(a) There are no comparable uncontrolled sales as defined in subparagraph (2) of this paragraph.

(b) An applicable resale price, as defined in subdivision (iv) or (v) of this subparagraph, is available with respect to resales made within a reasonable time before or after the time of the controlled sale.

(c) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. For this purpose packaging, repacking, labeling, or minor assembly of property does not constitute physical alteration.

(d) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property. See sec. 1.482-2(d)(3) for the definition of intangible property.

(iii) Notwithstanding the fact that one or both of the requirements of subdivision (ii)(c) or (d) of this subparagraph may not be met, the resale price method may be used if such method is more feasible and is likely to result in a more accurate determination of an arm's length price than the use of the cost plus method. Thus, even though one of the requirements of such subdivision is not satisfied, the resale price method may nevertheless be more appropriate than the cost plus method because the computations and evaluations required under the former method may be fewer and easier to make than under the latter method. In general, the resale price method is more appropriate when the functions performed by the seller are more extensive and more difficult to evaluate than the functions performed by the buyer (reseller). The principle of this subdivision may be illustrated by the following examples in each of which it is assumed that corporation X developed a valuable patent covering product M which it manufactures and sells to corporation Y in a controlled sale, and for which there is no comparable uncontrolled sale: [Examples omitted.]

Section 1.482-2(e)(1)(ii), Income Tax Regs., establishes a priority for the application of the pricing methods listed above. *Eli Lilly & Co. v. Commissioner, supra.* The comparable uncontrolled price method must be used first because "it is the method likely to result in the most accurate estimate of an arm's-length price (for the reason that it is based upon the price actually paid by unrelated parties for the same or similar products)." Comparable uncontrolled sales are sales of the same or substantially identical property between uncontrolled buyers and sellers. Sec. 1.482-2(e)(2)(ii), Income Tax Regs.

The regulations go on to provide that if there are no comparable uncontrolled sales, the resale price method is to be used. Sec. 1.482-2(e)(1)(ii), Income Tax Regs. This method involves calculating the arm's-length price of a controlled sale by the resale price to an uncontrolled buyer reduced by an appropriate markup. Sec. 1.482-2(e)(3), Income Tax Regs. The resale price method is most likely to result in an arm's-length price "where a manufacturer sells products to a related distributor which, without further processing, resells the products in uncontrolled transactions." Sec. 1.482-2(e)(1)(ii), Income Tax Regs. If all the standards for the application of the resale price method are not satisfied, either that method or the cost-plus method may be used—

> depending upon which method is more feasible and is likely to result in a more accurate estimate of an arm's-length price. A typical situation where the cost-plus method may be appropriate is where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly, or other processing of the product or adds significant value by reason of its utilization of its intangible property prior to resale in uncontrolled transactions. [Sec. 1.482-2(e)(1)(ii), Income Tax Regs.]

If none of the above methods is viable under the facts and circumstances in a particular case, a fourth "appropriate" method may be used. Sec. 1.482-2(e)(1)(iii), Income Tax Regs.

Petitioner asserts that the prices at which it sold to domestic dealers are "uncontrolled prices" since these sales are "uncontrolled sales" as defined in the regulations. However, petitioner contends that these prices unadjusted are not "comparable uncontrolled prices" since there are differences in the circumstances of the sales and the geographic market in which the product is resold. Petitioner contends that when properly adjusted, these "uncontrolled sales" produce "comparable uncontrolled prices."

Although in disallowing the entire 10-percent discount, respondent in effect used the actual sales to unrelated domestic dealers as "comparable uncontrolled prices," at the trial, his expert witnesses testified that some discount from the dealer net prices is needed to arrive at "comparable uncontrolled prices." The adjustments made by respondent's experts support some discount, but a discount less than 10 percent. Respondent's expert testified that the most accurate result in the instant case was obtained by using the comparable uncontrolled price method on parts and the resale price method on truck units to determine an arm's-length price for the sales between petitioner and Paccint. In applying the comparable uncontrolled price method, respondent's expert compared the parts sold by Paccint in the foreign market with those sold by Kenworth, Peterbilt, Dart, and PC & F in uncontrolled sales. The expert concluded that the following factors which could have an effect on price were the same for Paccint and petitioner's four divisions: quality of the product; character of the intangible property; time of sale; level of the market; and the geographic market in which the sale took place. The expert concluded that the terms and circumstances of sales between controlled and uncontrolled purchasers were not the same, and that this could have an effect on the price.

The expert testified that expenses relating to the cost of goods sold, other than the cost of purchasing merchandise, include engineering expense, field service expense, selling expense, parts overhead, division administrative expense, corporate administrative expense and repossession and bad-debt provisions. The expert found it difficult to determine which costs were avoided when petitioner sold to Paccint rather than to an unrelated purchaser. The expert reasoned that engineering costs would not be significantly reduced as a result of petitioner's sales to Paccint.

The expert concluded that petitioner's discount of 10 percent on sales of parts to Paccint was not justified, and computed the adjustment to the transfer price by adjusting the prices at which trucks and parts were sold to domestic dealers. Using the comparable uncontrolled price method on trucks and parts, the expert concluded that the transfer prices (after the

10-percent discount) from petitioner to Paccint should be increased for 1975, 1976, and 1977 in the amounts of $1,112,000, $4,302,000, and $3,359,000, respectively, for a total increase of $8,773,000.

Respondent's expert also used the resale price method to compute an arm's-length price between petitioner and Paccint on the sales of truck units. Sec. 1.482–2(e)(3)(ii), Income Tax Regs. Respondent's expert did not apply the resale price method to parts because, in his opinion, the sales effort associated with selling units and parts differs dramatically. According to respondent, allied equipment is sold in a bundle at one time while parts are sold continuously over a longer period of time. Pursuant to the resale price method, the expert determined the arm's-length price by taking the "applicable resale price" and reducing it by an amount he determined to be an "appropriate markup percentage." Sec. 1.482–2(e)(3)(vi), Income Tax Regs. The expert concluded that the truck units manufactured by Kenworth, Peterbilt, Dart, and PC & F were most similar to the allied equipment purchased and sold by Paccint in uncontrolled transactions. The expert determined there was similarity in the resales since the type of property involved in the sales was similar; the functions performed by the reseller with respect to the property were the same; the effect on price of any intangible property used by the reseller in connection with the resold property was comparable; and the geographic market in which the functions were performed by the reseller was identical. Sec. 1.482–2(e)(3)(vi)(*a*)–(*d*).

Using the resale price method on units and the comparable uncontrolled price method on parts, the expert concluded that petitioner's prices to Paccint should be increased for the years 1975, 1976, and 1977 in the amounts of $824,000, $5,024,000, and $2,964,000, respectively, for a total increase of $8,812,000.[17] Despite prior contentions to the contrary, respon-

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[17] Respondent's expert computed the figures for the period Sept. 1, 1975, through Dec. 31, 1975, based on the following table:

Analysis of Sale Using Resale Price Method on Units
and Comparable Uncontrolled Price Method on Sales of Parts
To Compute Appropriate Transfer Price on Intercompany Sales
9/1/75 - 12/31/75 (000's omitted)

Units	*Total*
Unit sales to Paccint—distributor net 9/1/75 - 12/31/75	$15,772

dent on brief argues that the comparable uncontrolled price method should not be used at all in the instant case because a significant difference exists in the level of the market between the sales to Paccint, a wholesaler, and sales to domestic dealers, who are retailers.

Petitioner's expert was of the opinion that applying the comparable uncontrolled price method resulted in a showing that the price petitioner charged Paccint in 1975 was 98.6 percent of the comparable uncontrolled price, for 1976 was 98.7 percent, and for 1977 was 102.6 percent. Petitioner's expert concluded that the controlled price between petitioner and Paccint when expressed as an average for the 3 years, 1975 through 1977, was 99.8 percent of the price indicated

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Less: Discount			($1,577)
Net selling price to Paccint			14,195
Paccint selling price of units			18,483
Less: Net cost to Paccint (above)			(14,195)
Gross margin			4,288
Margin on unit sales $4,288/18,483 = 23.20%			
Margin on other purchased equipment sales $1,106/5,794 = 19.09%			
Paccint sales	$18,483		
Margin at 19.09%	(3,528)		
Transfer price using margin on other purchased equipment	14,955		
Transfer price used	(14,195)		
Increase in transfer price			760
Parts			
Total sales of parts to Paccint 9/1/75 - 12/31/75	1,027	[This figure is incorrect.]	
Less: Discount taken	(103)		
Transfer price			924
Total sales of parts to Paccint 9/1/75 - 12/31/75	1,027		
Less: Discount at .0378 rate	(39)		988
Increase in transfer price on parts			64
Total increase in transfer price			824

Respondent's expert used a comparable computation to arrive at the adjustments for 1976 and 1977. The expert determined that Paccint's margin on allied equipment was 17.71 percent for 1976 and 15.91 percent for 1977.

pursuant to the comparable uncontrolled price method.[18]

Petitioner places great emphasis on the distinction between the domestic wholesaling function that petitioner performs and the export wholesaling function that Paccint performs. Petitioner contends that Paccint incurs greater expenses in servicing the overseas dealer network. Petitioner argues that performing the domestic wholesaling function internally results in a cost of roughly 6 percent of its price to domestic retail dealers, and that Paccint performs the export wholesaling function for petitioner and services the overseas dealer network at a cost of approximately 10 percent of the price to domestic retail dealers. Petitioner claims that Paccint assumed the management burden and risk that it would have otherwise assumed. An additional risk that Paccint assumed in petitioner's view was the possibility that Paccint might not recover its costs. Thus, petitioner argues, Paccint was properly allowed a 10-percent discount from the price at which petitioner sold to domestic dealers to account for the risk that Paccint would not recover its cost in the European market. Petitioner argues that although Paccint did in fact recover its costs and make a profit in 1975, 1976, and 1977, it would have failed to do so without the 10-percent discount in 6 out of 9 years.

However, petitioner also supported its transfer price under the resale price method by using Paccint's sales of allied equipment in computing a proper sales price to Paccint. Using

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[18] Petitioner's expert based his opinion on the following computation:

	1975	*1976*	*1977*	*Total*
	(Figures in thousands)			
Purchases from PACCAR	$53,593	$59,073	$47,049	$159,715
Discount at 10 percent	(5,359)	(5,907)	(4,705)	(15,971)
Controlled price	48,234	53,166	42,344	143,744
Purchases from PACCAR	53,593	59,073	47,049	159,715
Export wholesaling expenses incurred by PACCINT				
Selling expense	751	1,437	1,794	3,982
Interest expense on inventory	167	181	141	489
Division admin. expense	3,603	3,464	3,645	10,712
Corporate admin. expense	144	144	180	468
Total expenses	4,665	5,226	5,760	15,651
Comparable uncontrolled price—Purchases less expenses	48,928	53,847	41,289	144,064

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the resale price method, petitioner concluded that the price petitioner charged Paccint was 102.3 percent of the price derived from the resale price method in 1975, 95 percent in 1976, and 98.4 percent in 1977.[19]

Petitioner argues that Paccint is able to markup parts by a greater percentage and obtain a larger margin on parts than on units because the parts are built specifically for petitioner's trucks and the consumer has no other source for acquiring them. Petitioner argues that for this reason, sales of allied equipment to establish an appropriate markup percentage for both petitioner's truck units and parts is prejudicial rather than advantageous to petitioner.

It would be expected that Paccint would receive a different margin on parts than that received on allied equipment. There is testimony in the record to support petitioner's contention that the profit on parts is greater than on allied equipment. Although inconsistent with other positions he takes, respondent argues that Paccint had no profit on parts but all the profit went to petitioner. The record does not disclose the "profit" that Paccint had on parts but from the figures in the record it is clear that its "margin" on parts was less than on allied equipment. This could be true and its profit could be greater since there is some evidence in the record that Paccint's sales expense and certain other expenses in connection with the sale of parts was less than in connection with the sale of allied equipment and truck units. From the record in this case, we conclude that if any "profit" existed from the sales by Paccint of parts using the dealer net price less 10 percent as the cost of those parts, that profit was reflected as Paccint's profit on the records of Paccint.

It is necessary to determine the adjustment, if any, which should be made to the transfer prices of both truck units and parts. Because of the differences in the nature of the items, the proper adjustment, if any, will be separately considered with respect to truck units and parts.

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[19] Petitioner's expert's computation for 1976 and 1977 resulted in the same profit margin on allied equipment as the computation made by respondent's expert. There is a difference for the period Sept. 1 through Dec. 31, 1975. However, the computation for the period Sept. 1 through Dec. 31, 1975, of respondent's expert is more accurate. Apparently, some of the figures used by petitioner are based on full-year operations using Paccar International costs and sales for the first 8 months of 1975.

While the record shows that sales of allied equipment are comparable to sales of truck units, it is questionable whether sales of allied equipment by Paccint are comparable to its sales of parts. The regulations provide that the most important characteristics to be considered in determining the similarity of resales include the type of property involved in the sale and the functions performed by the reseller with respect to the property. Sec. 1.482–2(e)(3)(vi), Income Tax Regs. The record shows that parts are generally sold by Paccint at a different time than allied equipment. Parts are only sold by Paccint when a customer has a need for a replacement part. In addition, Paccint's accounting method for the sale of parts is different from that for the sale of allied equipment. Paccar invoices Paccint's customers for the parts sold by Paccint, but Paccint directly invoices the customers for the sales of allied equipment. Allied equipment is sold as a means of selling the truck unit. Allied equipment is always sold as part of a package with one of the trucks sold to Paccint by petitioner.

On this record, we conclude that there are no comparable uncontrolled sales prices of truck units or parts due to the difference in the geographic market in which Paccint sales were made and domestic sales were made and the different terms of sales by Paccint, a wholesaler, and petitioner's divisions who sold direct to dealers. Sec. 1.482–2(e)(2)(ii), Income Tax Regs. The uncontrolled sales made by petitioner's divisions, Kenworth, Peterbilt, Dart, and PC & F, were made solely in the domestic market. Although Paccint was a domestic corporation, its sales were solely in the foreign market and the record reflects that added marketing expenses were associated with such sales. Petitioner has not, however, established the added cost of marketing abroad and maintaining a selling staff in foreign nations. Consequently, the use of the "comparable uncontrolled sales" method in this case is not appropriate.

To establish a transfer price on petitioner's sales of truck units to Paccint, we adopt the approach of respondent's expert in determining the resale price method. Based on the computation of respondent's expert, we increase petitioner's transfer price to Paccint of truck units by the amounts of $760,000, $3,927,000, and $1,777,000, respectively, for the period September 1, 1975, through December 31, 1975, and the years 1976 and 1977.

Petitioner's records show that for the period September 1, 1975, through December 31, 1975, and the years 1976 and 1977, petitioner sold parts to Paccint totaling $2,097,441, $16,200,000, and $16,546,000, respectively, prior to the allowance of the 10-percent discount. This discount does not separately show on petitioner's books. However, the 10-percent discount allowed was on the total sales by petitioner to Paccint of trucks and parts. We therefore conclude that the 10-percent discount was allowed on sales of parts. The actual amount of Paccint's sales of parts does not separately show on the documents in this record. However, Paccint's margin is shown and in the context of the records on which it is shown, we conclude and have found this margin to be the difference between the prices charged by petitioner to Paccint before the 10-percent discount allowance and the total sales amount received by Paccint from the sales of parts. Adding the margin shown on Paccint's records to petitioner's undiscounted sales prices to Paccint for parts results in sales by Paccint for the period September 1, 1975, through December 31, 1975, of $2,178,000 and for the years 1976 and 1977 of $16,304,000 and $16,750,000, respectively. As is apparent from these figures, petitioner's profit margin on parts even after the 10-percent discount was in the range of from 11.82 to 15.35 percent for the period and years here involved. This is less than the margin on allied equipment.[20]

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[20] The actual margin per computation is:

Parts	*Sept. 1, 1975— Dec. 31, 1975*	*1976*	*1977*
Total sales of parts to Paccint (distributor net)	$2,098,000	$16,200,000	$16,546,000
Less 10% discount taken	209,800	1,620,000	1,654,600
Net selling price to Paccint (controlled price)	1,888,200	14,580,000	14,891,700
Paccint selling price on parts	2,178,000	16,304,000	16,750,000
Paccint's margin on parts	80,000	104,000	204,000
Paccint's profits on parts	290,000	1,724,000	1,859,000
Percentage rate of profit on Paccint's resale of parts using the controlled price and cost	15.35%	11.82%	12.48%

We recognize that some of the expenses which Paccint had in connection with the sale of truck units to its customers were borne by petitioner with respect to parts. The record is clear that the invoicing of parts sales by Paccint was done by petitioner. There is an indication in the record that some parts may have been shipped by petitioner to Paccint customers. However, even considering these factors, we conclude that because of the relatively lower margin between costs and sales price on parts sold by Paccint as compared to allied equipment, the 10-percent discount results in a price of parts to Paccint comparable to a price which would have been charged by petitioner in an arm's-length transaction. We therefore conclude that no adjustment is necessary with respect to parts sales.

Petitioner argues that the adjustment to the prices to Paccint of trucks is so small that we should consider it de minimus. We do not agree. The adjustment in one year is close to 5 percent and in the other years is also substantial in amount. We therefore hold that petitioner's sales price of trucks and parts to Paccint should be increased by $760,000 for the period September 1, 1975, through December 31, 1975, and by $3,927,000 and $1,777,000 for the years 1976 and 1977, respectively. This results in decreasing the discount of petitioner to Paccint, increasing Paccint's costs of goods sold, decreasing Paccint's income, and reducing the DISC deferral available to Paccar and its subsidiaries.

Decision will be entered under Rule 155.

FRANK A. AND CHARLOTTE T. LEAMY, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 29126–83. Filed November 18, 1985.

Petitioner Frank A. Leamy was an airline pilot based in San Francisco and Dallas. Charlotte T. Leamy was a school teacher in San Diego, where she lived with petitioners' children. Frank and Charlotte owned an incorporated travel agency in San Diego where Frank spent most of his non-flying time. Frank was active in the business and incurred travel and entertainment expenses related thereto. Neither petitioner received any income from their travel agency activities. *Held*: Petitioners were not in the business of being independent commissioned travel agents. The expenses they incurred were for the benefit of the travel agency and are not deductible by petitioners.

Michael Wells, for the petitioners.
Miles D. Friedman, for the respondent.

DRENNEN, *Judge*: Respondent determined the following deficiencies and additions to tax in petitioners' Federal income tax:

Year	*Deficiency*	*Addition to tax sec. 6651(a)*[1]
1979	$5,127	$524
1980	5,384	330

After concessions[2] by both parties, the issues for our decision are: (1) Whether petitioners Frank A. and Charlotte T. Leamy were engaged in the trade or business of being travel agents and may therefore deduct travel, automobile, and entertainment expenses incurred by them in 1979 and 1980 either as ordinary and necessary business expenses or as unreimbursed employee business expenses; and (2) whether petitioners may deduct expenses incurred by petitioner Frank Leamy in traveling from Dallas to San Diego and from San Francisco to San Diego as away from home travel expenses incurred in traveling between two places of business. If petitioners are found to not be engaged in the trade or business of being travel agents, we will address the issue of whether their travel expenses are deductible as educational travel expenses.

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years at issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Prior to trial, respondent conceded that no additional tax was due under sec. 6651(a) for 1980, while petitioners conceded the imposition of such tax for 1979. In addition, petitioners conceded that they are not entitled to deductions for the following: (1) Depreciation adjustments on a motorhome in the amount of $2,275 for 1979 and $2,275 for 1980; (2) hotel expenses in 1979 and 1980 of $1,040 and $1.274, respectively; and (3) parking lot fees in 1980 of $216.

FINDINGS OF FACT

Some of the facts have been stipulated and they are so found. The stipulations of fact and joint exhibits are incorporated herein by this reference.

Petitioners Frank A. and Charlotte T. Leamy (hereinafter referred to as Frank and Charlotte, or petitioners) were legally married, but living separately, when their joint returns and the petition in this case were filed. Frank lived in Carrolltown, Texas, and Charlotte lived in San Diego, California. Petitioners filed their 1979 and 1980 individual income tax returns with the Internal Revenue Service Center in Austin, Texas. For purposes of determining jurisdiction in the event of an appeal in this case, the parties have stipulated that petitioners' residence was San Diego, California, at the time this petition was filed.

During the years at issue, Frank was a pilot for American Airlines and Charlotte was a full-time school teacher for the Poway Unified School District in or near San Diego, California. Charlotte lived in a house owned by petitioners in San Diego with two children. For the first half of 1979, Frank's base of operations for American Airlines was San Francisco. For the remainder of 1979, plus all of 1980, Frank's base of operations was Dallas, Texas. Frank spent about one-half of his time in San Diego and the rest of his time was spent flying for American Airlines. Frank and Charlotte purchased a townhouse in Carrolltown, Texas, near Dallas, for Frank's use while he was based in Dallas. They rented the townhouse to Frank's brother for an amount sufficient to cover the mortgage payments. When Frank was not flying, he traveled to San Diego where he stayed with the family. Frank chose to be based outside of San Diego for economic reasons, and he had sufficient seniority to choose where he wished to be based for American Airlines. Frank and Charlotte had some marital problems during this time but were never legally separated. Petitioners claimed $1,440 in 1979 and $1,685 in 1980 as amounts which were substantiated for away from home travel expenses for Frank's transportation and travel from San Francisco and Dallas to and from San Diego.

In 1977, petitioners purchased a travel agency in San Diego called Vacations Unlimited (VU). VU was a California corporation incorporated in 1971. Frank owned 60 percent of VU's stock, and Charlotte owned the remaining 40 percent.[3] Frank testified that during the years at issue, VU had actual gross sales of about $1.4 to $1.6 million dollars. VU had two different kinds of employees, salaried employees and commissioned employees. Salaried employees were paid a regular salary. During the years at issue, VU had from three to eight salaried employees. Commissioned employees negotiated their compensation with VU. Commissions negotiated ranged from 40 to 60 percent of the income they generated for VU.

Corporate policy at VU[4] allowed for the reimbursement of certain employee expenses. The basic cost of company-designated familiarization trips, or "FAM trips" as they are called in the travel agency business, which were taken by salaried employees were paid for by VU.[5] The salaried agents were paid their full salaries while on these trips. FAM trips are trips taken by sales employees to allow the employees an opportunity to become familiar with a travel-related area, a particular tour or cruise, or a specific program. Sometimes FAM trips are sponsored by Government agencies or other groups that bear part of the expense. Trips that were not company-designated but were instead, voluntary, i.e., the employee chose to take the trip of his own accord, were not reimbursed by VU. The decision as to what was a company-designated FAM trip and would therefore be reimbursed by VU was made either by VU's president, Frank; its vice president, Charlotte; or the office manager, Daniel Wise (Wise).[6] VU's corporate policy allowed the reimbursement of 50 percent of the cost of a company-designated FAM trip taken by a commissioned employee. Frank stated that while the policy existed allowing reimbursement of commissioned employees, in practice, VU never reimbursed any commissioned employees. Employees were not required to take FAM trips, but Frank stated that virtually every agent in VU's office traveled on at least one FAM trip per year. Corporate policy also provided for reimbursement of legitimate business expenses. Generally, all expenses of salaried employees were paid by VU, while expenses of commissioned employees were split.

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[3] Prior to petitioners' complete ownership of VU's stock, several individuals held minor interests in the corporation. We do not detail these interests for they are not relevant to our decision.

[4] Petitioners introduced a document into evidence at trial that described the corporate policies of VU. Several sections in the manual were crossed out sometime during 1979 and 1980 by Frank.

[5] "FAM" trips were usually planned or arranged by airlines, resort areas, or others who benefited from tourist travel. These were offered to travel agents at discounted prices in the hope that the agents would direct more tourists to their activities.

[6] Frank stated that he made the determination that his FAM trip in 1979 was not company designated.

Petitioners were at all times during the years at issue treated as commissioned sales agents by their own choice. They both signed agreements on May 30, 1977, to serve as outside sales employees of VU and to receive a 50-percent net commission for any sales they made. After purchasing VU, Frank acted as its president, while Charlotte was vice president and secretary.

On October 1, 1978, petitioners called a special meeting of VU's board of directors to issue an announcement which stated that no officer or director at VU was to receive more than $1 a year for his or her work as officer or director. In addition, the announcement provided that normal expenses were to be paid for travel and other business expenses. Petitioners also agreed to give up any commissions they would have received and accept $1 as full payment for their efforts. Frank stated that the reasons for these changes in policy were a poor cash flow and the need to conserve cash because of VU's move to a new office location. At trial, no corporate books or records were presented by petitioners as evidence of VU's financial situation. During the years at issue, neither Frank nor Charlotte applied for, or received, any sales commissions. Frank and Charlotte also did not receive any salary or dividends while they owned the company.

Frank received his training as a travel agent in 1971 in Chicago where he attended the International Travel Training School for 2 months. He then served as an outside sales agent for Around the World Travel, in Palatine, Illinois. Frank was a member of the American Society of Travel Agents (ASTA) and the International Air Traffic Association (IATA). Neither of these organizations required that Frank take any continuing education courses to maintain his membership. Through his interest in the travel agency business, Frank met the owner of VU, and then subsequently purchased VU.

Charlotte also had worked with Around the World Travel in Palatine, Illinois. Charlotte was not as actively involved with VU as Frank. She stated that she worked at VU during the summer of 1977 and 1978. Wise stated that Charlotte was in VU's office infrequently. He stated that all employees were to submit a list of clients to him for which they sought sales commissions, but he never received any such list from Charlotte. Charlotte did not offer any records to show that she had earned sales commissions.

Travel Expenses

After purchasing VU, petitioners made several trips incurring expenses for which they now seek deductions. Petitioners attended the ASTA World Congress (World Congress) in Munich in 1979. The World Congress was a trade show for travel agents. Frank and Charlotte were particularly interested in this meeting since VU specialized in European tours, and the meeting was held in Europe with many representatives from European countries. Frank viewed the trip as an "educational experience" because it gave Charlotte and him the opportunity to meet with the European tour operators first hand and to find out what they were offering. The World Congress lasted for a week from October 21 to 26. Frank and Charlotte attended the World Congress for 4 days. Charlotte then returned to San Diego, and Frank traveled to France, Paris, and London. Petitioners claimed $2,939 which has been substantiated as expenses for travel, meals, lodging, and seminar costs of attending the World Congress.

Frank traveled to France to meet with the tourism director of "Floating Through Europe." Floating Through Europe was a company that arranged trips on a floating barge between Lyon and Dijon, France. Frank was in the process of chartering the barge for a tour scheduled the following year. Frank then went to Paris to meet with representatives of several tour companies that specialized in ski programs. He stated that he was trying to arrange tours that combined British and American tourists in the same group. Frank then returned to the United States.[7]

In 1979, Frank took a ski trip to France. The trip was a FAM trip. Frank was approached by Air France about this trip because he had previously taken a ski tour group to France aboard Air France and it was a way for Frank to view the new high-altitude ski resorts in France. Frank claimed a deduction of $854 as expenses which have been substantiated for travel, meals, and lodging for this trip.

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[7] It is unclear from the record, but it appears that the cost of Frank's trip to France is included in the expenses deducted for travel to the World Congress.

Petitioners sought a deduction for three trips in 1980, one to Park City, Utah; one to France; and one to Cleveland, Ohio. The trip to Park City, Utah, was a ski trip. Petitioners had arranged it as a package trip for 16 people. Frank and Charlotte acted as "escorts and counsel" to the people on the trip. The trip to France in 1980 was to take a group aboard a floating barge. Frank and Charlotte had arranged the 3-week trip with Floating Through Europe. Nineteen people went on the trip. The trip was arranged by promotional nights that petitioners held at their home in San Diego for 9 months. The trip was promoted as an escorted trip. The credibility of the trip was enhanced by the fact that Charlotte and Frank went along as escorts since they had both been to France, and he had seen the barge, met the captain, and was familiar with the itinerary. Petitioners deducted $4,975 as expenses which have been substantiated for travel, meals, and lodging for this trip to France.

Petitioners were alumni of Kent State University in Ohio. They made a trip to Cleveland, Ohio, in 1980 to meet with other Kent State alumni and with officials of the alumni association to give a presentation on European travel. Petitioners had discussed with the alumni association the possibility of arranging some alumni group travel. Petitioners claimed $427 in 1980 as amounts which have been substantiated for their travel, meals, and lodging to Cleveland, Ohio.

Two persons who had been employed by VU, Wise (the office manager) and Kathleen Zavinsky (Zavinsky), and Bet Townley (Townley), an employee of British Caledonian Airways, testified as to their knowledge of FAM trips. Zavinsky was employed by VU in 1978 and 1979, as an outside sales agent. Zavinsky met the petitioners through her job as an instructor at Mesa College. She taught students entry-level skills for becoming travel agents and some of her students served as interns at VU. Zavinsky stated that to be offered a FAM trip, a person had to be very qualified and visible in the industry. In her opinion, an absentee owner would not be asked to go on a FAM trip. She viewed the trips as very educational and as customary in the industry. She also viewed Frank as a very ethical and knowledgeable person.

Wise had taken FAM trips, and he viewed them as an opportunity "to gain an education background in the destination" of the trip. He viewed the trips as customary and as a great sales tool. Wise stated that in his opinion Frank was an active manager of VU. He also stated that Frank was a competent travel agent with a favorable reputation.

Townley testified that she had met Frank in April of 1982. She stated that he worked with her in 1982 and 1983 on a book she was writing about travel to Britain. Townley stated that British Caledonian "hand-picked" the people it offered FAM trips. She stated that the people chosen were those working full time in the industry. In her opinion, Frank was a very professional and knowledgeable person.

Automobile Expenses

Petitioners claimed a deduction on their 1979 Federal income tax return for unreimbursed automobile expenses. This deduction included $1,401.36 for the leasing of the automobile; $1,736 for operating expenses; and $67 for registration fees and use tax. These amounts have been substantiated.

The automobile was leased in Frank's name and was used by Frank and Charlotte in driving from their home in San Diego to VU's office and returning. Other VU personnel including Wise (the office manager), a bookkeeper, and an outside sales employee used the automobile to perform various errands for the corporation. Wise stated that operating expenses incurred in the use of the car were reimbursable by petty cash disbursements. No evidence was presented that petitioners sought reimbursement for these expenses from VU or that VU offered to pay for the automobile expenses.

Entertainment Expenses

Petitioners claimed a deduction in 1979 of $340 for entertainment expenses. This amount has been substantiated. The parties have stipulated that if either of the petitioners is held to be engaged in the trade or business of being a travel agent, then all of the entertainment expenses are deductible. If we find that neither of the petitioners is in that trade or business, then the entertainment expenses are not deductible.

OPINION

As we understand it, petitioners' principal contention is that they were individually and independently in the business of being commissioned travel agents, and that the expenses they incurred for travel, entertainment, and the use of an automobile were deductible as ordinary and necessary expenses of conducting that business, or for education which maintained and improved their skills required in that business. Alternatively, they contend the expenses are deductible as unreimbursed employee business expenses. Petitioners also contend that Frank's expenses incurred in traveling from San Francisco and Dallas, stipulated to be his tax homes, to San Diego are deductible as expenses incurred in traveling from one place of business to a second place of business.

On the other hand, respondent contends that none of the expenses are deductible because petitioners were not individually engaged in the business of being travel agents; the travel agency business was that of VU. Nor are they deductible as unreimbursed employee business expenses because if the expenses were incurred for the benefit of VU, petitioners could have been reimbursed by VU had they asked for reimbursement. Respondent also contends that Frank's traveling expenses between San Francisco-Dallas and San Diego were nondeductible, commuting expenses incurred primarily to be with his family in San Diego, rather than for business purposes. Respondent concludes by noting that petitioners' efforts to deduct the above expenses are an attempt to convert corporate business expenses into deductible personal business expenses.

In our opinion, the principal and decisive issue is whether petitioners' activities in connection with VU constituted a separate and independent business of petitioners.[8] If they do not, we cannot find that the expenses involved are deductible by petitioners as ordinary and necessary, or educational, expenses of petitioners' personal business, or as unreimbursed employee business expenses. If petitioners' activities did constitute a separate and independent business of petitioners, we would have to conclude that at least a part of the expenses involved were deductible as ordinary and necessary business expenses.

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[8] While Charlotte did occasionally participate in the activities of VU, Frank's activities are the ones with which we are most concerned. It does not appear that Charlotte acted independently of Frank with respect to the travel agency business. Our conclusions on the trade or business issue with respect to Frank are equally applicable to Charlotte.

Without deciding, because it is not necessary to do so, we believe that many of the travel, transportation, and entertainment expenses here involved would qualify as ordinary and necessary business expenses of an independent travel agent. The " FAM " trips provide the agent with firsthand information with respect to the interesting things that can be seen and done at various places; the comfort, convenience, and condition of facilities at those places; the cost and availability of transportation to and from those places; the types of people and services the traveler can expect; and many other things that will be of interest to a prospective customer. Such information can be converted into income from sales of the services a travel agency sells to the public. A personal knowledge from experience with the ski slopes in a particular area may well convince a skier-customer to visit a particular area the agent is promoting, rather than some other area the skier has heard of. And the utilization of knowledge acquired on trips in speaking to groups contemplating tours may also produce revenue for a travel agent.[9]

However, we cannot find from the evidence in this case that petitioners have proved that their activities in connection with VU constituted a separate personal trade or business of petitioners during the years involved. The evidence is convincing that Frank, at least, was an experienced and knowledgeable travel agent who probably could have been a successful commercial travel agent on his own or could have been a valuable employee of a travel agency. But Frank and Charlotte chose to be neither. They drew no salaries nor dividends from VU, and by written agreement precluded themselves from receiving any commissions for business they produced for VU. To be in a trade or business, one must intend to make a profit. *American Properties, Inc. v. Commissioner*, 28 T.C. 1100 (1957), affd. 262 F.2d 150 (9th Cir. 1958); *Hirsch v. Commissioner*, 315 F.2d 731, 736 (9th Cir. 1963). See *Dreicer v. Commission-*

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[9] We recognize that this can be overdone and result in the Government's picking up part of the tab for an agent's vacation trips, but there is no evidence that this was being done by the instant petitioners.

er, 78 T.C. 642 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); *Fuchs v. Commissioner*, 83 T.C. 79 (1984). The only profit from the travel agency business foreseeable by petitioners under the circumstances as they existed in 1979 and 1980 was from taxes. "Profit" in this context means economic profit, independent of tax savings. *Beck v. Commissioner*, 85 T.C. 557 (1985). Petitioners did not even intend to receive any income from their traveling activities. The corporation reaped the income from petitioners' activities and yet paid none of petitioners' expenses and nothing for petitioners' efforts in producing the income. Instead, petitioners, while including nothing in their taxable income for their efforts, are claiming deductions for expenses which they set off against their other taxable income to reduce their individual taxes.

Furthermore, petitioners' arrangements with their corporation, VU, could build up the value of the corporate stock, which petitioners could subsequently access as capital gain by selling the stock.[10] However, such a profit would not be a direct product of their business as independent travel agents. It would arise as a result of their ownership of VU. Such prospective profit does not provide the necessary profit motive for the business of being independent travel agents. *Bessenyey v. Commissioner*, 45 T.C. 261 (1965), affd. 379 F.2d 252 (2d Cir. 1967).

Neither do the expenses here involved qualify under section 212 as ordinary and necessary expenses incurred for the production or collection of income. They produced no current income, and there is not the necessary nexus between the expenses incurred and a profit that might be realized on the subsequent sale of the business. In this context, they would be a contribution to the capital of VU.

Respondent's determination that petitioners were not in the trade or business of being travel agents is presumed to be correct, and petitioners have the burden of overcoming that presumption. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a). They have failed to do so.

The evidence is clear that the travel agency business in which petitioners participated was that of their wholly owned corporation, VU. VU had three to eight employees, other than petitioners, who worked for and in the agency. Apparently all the reservations and ticketing were arranged through VU, and all the income from the travel agency activities was funneled into VU. We have no doubt that petitioners' activities aided the business of VU. But petitioners received no income from such activities—VU did. The expenses which petitioners incurred and claimed as deductions in these years all related to the business of VU. Those expenses were either business expenses of VU or personal expenses of petitioners. In neither case are they deductible by petitioners. It is well established that, absent a binding agreement, a taxpayer may not deduct expenses incurred for the benefit of others. *Noland v. Commissioner*, 269 F.2d 108, 109 (4th Cir. 1959). Thus corporate officers, employees, and shareholders who voluntarily incur corporate expenses are not entitled to a deduction for those expenses because they are not considered necessary employee expenses. *Westerman v. Commissioner*, 55 T.C. 478, 482 (1970).

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[10] Since petitioners failed to produce any of the books, records, or tax returns of VU, we do not know whether VU paid income taxes during the years here involved, or whether petitioners realized capital gain upon the sale of VU in subsequent years.

It is also a well settled premise that a corporation and its shareholders are separate entities. *Low v. Nunan*, 154 F.2d 261 (2d Cir. 1946). A corporation's business is separate from the business of its shareholders, officers, or employees. None of the latter may deduct as personal expenses those expenses that further the business of the corporation. *Kahn v. Commissioner*, 26 T.C. 273 (1956). We are convinced that the expenses here involved related to the business of VU and not to what could be considered a trade or business of petitioners.[11]

Petitioners have presented an alternative argument in seeking a deduction for their travel expenses. Petitioners argue that their expenses for travel should be allowed as an educational travel expense under section 162(a).

Educational expenses are deductible business expenses when the education maintains or improves the skills required by an individual in his or her employment or other trade or business, or if the education meets the express requirements of the taxpayer's employer imposed as a condition to the retention of his employment relationship, status, or rate of compensation. Sec. 1.162-5(a), Income Tax Regs.

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[11] As an additional reason for denying petitioners' deduction, we are not convinced that they could not have been reimbursed for these expenses by VU. The evidence presented by petitioners concerning VU's reimbursement policy was unclear. Portions of the document had been crossed out by Frank, and it was unclear which policies were effective at what time. However, VU did provide that commissioned employees could be reimbursed for one-half of their legitimate business expenses. Assuming that this policy was adhered to, since petitioners did not seek reimbursement, they may not now seek a deduction for the expense. See *Podems v. Commissioner*, 24 T.C. 21 (1955); *Drury v. Commissioner*, T.C. Memo. 1977-199.

We have held that petitioners were not in the trade or business of being travel agents; therefore, they do not meet the threshold requirement of incurring the expense in a trade or business under section 162. In addition, the travel was not required as a condition of the petitioners' employment, or necessary for their maintenance of a certain status or rate of compensation. Therefore, we must deny petitioners' deduction for travel expenses under this alternative argument.

Automobile Expenses

Petitioners claimed a deduction in 1979 of $2,844.36 for unreimbursed automobile expenses. These expenses were incurred by petitioners for an automobile that was driven by them from their home to VU and was also used by other employees of VU to run errands for the corporation.

Personal expenses incurred by a taxpayer in commuting from his home to his job are not deductible. Sec. 1.162-2(e), Income Tax Regs.; *Green v. Commissioner*, 59 T.C. 449 (1972). Therefore, any expenses incurred by petitioners in driving the automobile from their home in San Diego to VU's office is not deductible. Nor may petitioners deduct the automobile expenses as unreimbursed employee expenses under section 162. See, e.g., *Snarski v. Commissioner*, T.C. Memo. 1981-328. There is no evidence that petitioners sought reimbursement for these expenses from VU, and petitioners have not carried their burden of proving that the expenses could not have been reimbursed by the corporation. See, e.g., *Podems v. Commissioner*, 24 T.C. 21 (1955). The automobile expenses were an expense of the corporation since the automobile was used by corporate employees to carry on the corporation's business. It is not permissible to shift what appears to be a legitimate corporate expense, deductible by the corporation, to a taxpayer who seeks a personal deduction even though the taxpayer is the owner of the corporation. *Snarski v. Commissioner, supra.* Accordingly, we uphold respondent's determination denying petitioners' deduction for automobile expenses.

Entertainment Expenses

We have held that neither of the petitioners was independently engaged in a trade or business in 1979 or 1980. Therefore, according to the stipulation of the parties, respondent's determination denying a deduction for entertainment expenses is sustained.

Away From Home Travel Expenses

Petitioners seek to deduct expenses incurred by Frank in traveling from Dallas to San Diego and from San Francisco to San Diego. Respondent argues that these expenses are not deductible because they are a personal expense incurred by Frank in commuting from his job with American Airlines to San Diego to be with his family. The parties have stipulated that Dallas and San Francisco were Frank's "tax homes" in 1979 and 1980. Therefore, these expenses were incurred in Frank's traveling from his tax homes to San Diego. See *Commissioner v. Mooneyhan*, 404 F.2d 522 (6th Cir. 1968). We need not determine whether Frank's primary motivation in traveling to San Diego was to be with his family or for business reasons. We have found that Frank's involvement with VU did not constitute an independent trade or business; nor was he an employee of VU. Therefore, these expenses are not deductible by petitioners as expenses incurred by Frank in traveling between two businesses. However, it is our belief that Frank's primary motivation for traveling from Dallas and San Francisco to San Diego was to be with his family. Frank did mention that he and Charlotte were having some marital problems, but he stated that they were never legally separated or divorced. Frank also stated that it was his "economic choice" to be based outside of San Diego; he was not forced by his employer to live in Dallas or San Francisco since he had sufficient seniority to choose where he wished to be based for American Airlines. See *Green v. Commissioner, supra*. It is also our belief that whether or not Frank had spent time at the offices of VU, he would still have traveled to San Diego after he finished a flight for American Airlines, because that is where his family resided. Accordingly, respondent's determination denying petitioners' deduction for Frank's away from home travel expenses is sustained.

To reflect the parties' concessions and our disposition of the disputed issues,

Decision will be entered under Rule 155.

KARL L. DAHLSTROM AND CLARA J. DAHLSTROM, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 19904–83. Filed November 19, 1985.

Held, Ps' motion under Rule 90(c), Tax Court Rules of Practice and Procedure, to enlarge the time in which to answer R's requests for admission, Ps' motion under Rule 90(e) to withdraw or modify deemed admissions and Ps' motion for a protective order will be denied. *Held, further,* R's motion to compel responses to R's interrogatories to Ps and to compel production of documents or to impose sanctions under Rule 104(c) will be granted. *Held, further,* R's motion for summary judgment under Rule 121 will be denied.

Karl L. Dahlstrom and Clara J. Dahlstrom, pro se.
David W. Johnson and *Sheri Wilcox*, for the respondent.

OPINION

NIMS, *Judge*: This matter is before the Court on petitioners' motion for extension of time to answer requests for admission, petitioners' motion to withdraw admissions, petitioners' motion for a protective order, respondent's motion for summary judgment pursuant to Rule 121,[1] and respondent's motion to compel responses to respondent's interrogatories to petitioners and to compel the production of documents or to impose sanctions under Rule 104(c).

Respondent determined deficiencies in and additions to petitioners' Federal income tax as follows:

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[1] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure. All section references are to the Internal Revenue Code of 1954 in effect for the years in question and currently in effect.

Year	Deficiency	Additions to tax sec. 6653(b)
1977	$155,733	$77,866.50
1978	341,689	170,844.50
1979	788,152	394,076.00

Petitioners Karl L. Dahlstrom (petitioner) and Clara J. Dahlstrom, husband and wife, resided in Texas at the time their petition was filed.

During the years in issue, petitioner promoted and sold a tax shelter program he had devised utilizing foreign trust organizations. On June 2, 1981, a grand jury empaneled in the Western District of Washington indicted petitioner for aiding and assisting others in the preparation of false income tax returns and unlawfully impeding and impairing the lawful functions of the Internal Revenue Service as a result of his promotion and sale of this tax shelter program. On March 8, 1982, the District Court for the Western District of Washington convicted petitioner of these charges. The Ninth Circuit, however, reversed petitioner's conviction in *United States v. Dahlstrom*, 713 F.2d 1423 (9th Cir. 1983), cert. denied 466 U.S. 980 (1984), finding that the evidence was insufficient to support the conviction.

Subsequent to petitioner's criminal conviction, respondent conducted a civil examination of petitioners' income tax returns for the years in issue. On November 22, 1982, the United States filed an ex parte motion with the District Court for the Western District of Washington requesting disclosure to the Examination Division of the Internal Revenue Service of all documents and records relating to petitioner which were presented to the grand jury. On December 7, 1982, the court entered an order pursuant to rule 6(e), Federal Rules of Criminal Procedure, authorizing disclosure of the requested documents and records. Before the grand jury materials were delivered to respondent, however, the court vacated its rule 6(e) order and granted a continuance to allow petitioner to respond to respondent's disclosure motion. The District Court subsequently entered a rule 6(e) order granting respondent's motion for disclosure on January 26, 1983.

On March 12, 1984, the Ninth Circuit, relying on *United States v. Baggot*, 463 U.S. 476 (1983), vacated the District Court's January 26, 1983, disclosure order and instructed respondent to return all grand jury materials previously disclosed. Respondent subsequently returned these materials to the Tax Division of the Department of Justice.

On April 15, 1983, respondent issued to petitioners a notice of deficiency on which he determined that petitioners had failed to pay tax on substantial amounts of income earned from the sale of the above-mentioned tax shelter program. Respondent further determined that all or part of the tax underpayment was due to fraud. On July 12, 1983, petitioner filed a petition disputing the income tax deficiencies and additions to tax for fraud set forth in the notice of deficiency. On October 21, 1983, respondent timely filed an answer denying petitioners' assignment of errors and affirmatively alleging that all or part of petitioners' underpayment of tax for the years in issue was due to fraud. Petitioners timely filed a reply denying respondent's affirmative allegations of fraud on December 19, 1983.

On May 21, 1984, petitioners received respondent's letter informally requesting that petitioners answer certain questions, produce certain documents, and stipulate certain facts relevant to the issues in dispute. Petitioners refused to cooperate with these informal discovery requests, claiming that the information requested was based on grand jury materials which the Ninth Circuit had ordered respondent to return.

On June 8, 1984, as a result of petitioners' failure to cooperate with respondent's informal discovery requests, respondent served on petitioners requests for admission pursuant to Rule 90, a request for production of documents pursuant to Rule 72 and interrogatories pursuant to Rule 71. Respondent also notified petitioners by letter that the discovery requests were not based on grand jury materials.

On July 30, 1984, having received no response to his formal discovery requests, respondent filed a motion to compel responses to respondent's interrogatories to petitioners and to compel the production of documents or to impose sanctions under Rule 104(c). On September 10, 1984, petitioners filed numerous objections in response to that motion. On September 11, 1984, petitioners filed a motion for a protective order requesting the Court to limit respondent's discovery to taxable year 1979 and served on respondent objections to the requests for admission. However, because petitioners' response to the requests for admission was served on respondent more than 30 days after service of the requested admissions, the facts and exhibits set forth therein were deemed admitted on July 9, 1984, pursuant to Rule 90(c). *Freedson v. Commissioner*, 65 T.C. 333, 334–336 (1975), affd. 565 F.2d 954 (5th Cir. 1978).[2] The admitted facts and exhibits establish the following:

On April 2, 1973, petitioners executed a document entitled "Declaration of Trust of this Constitutional Trust" in the name of "Trust Publications." On the same date petitioners, as trustees of Trust Publications, also executed "Trustees' Declaration of Purpose of this Constitutional Covenant."

During 1977, 1978, and 1979, petitioner promoted and sold a tax shelter program he had devised utilizing foreign trust organizations. Sales of the program took the form of sales of memberships in an organization that petitioner had formed called the American Law Association (ALA). Purchasers of membership were entitled to receive instruction and materials relating to the tax shelter program at seminars conducted by the ALA. Members attending these seminars were charged fees ranging from $6,000 to $12,000.

During 1977, petitioner had signatory authority on bank accounts in the name of Trust Publications at the Citizen's State Bank, Bryan, Texas and the First Bank of Snook, Snook, Texas. Fees totaling $244,372.10 from the sale of ALA membership were deposited in these accounts during 1977.

During 1978, in addition to the bank accounts identified above, petitioner had signatory authority on bank accounts in the name of Trust Publications at the University National Bank in Bryan, Texas. Membership fees totaling $483,757.62 were deposited in these accounts during 1978.

During 1979, membership fees of $938,221.39 were deposited in the bank accounts in the name of Trust Publications at the First Bank of Snook and the University National Bank.

From 1978 through 1980, amounts totaling $1,063,100 were transferred from the bank accounts in the name of Trust Publications at the Bank of Snook and the University National Bank to two bank accounts in the names of International Clearing House and Information Services International, respectively. Petitioner had signatory authority on both accounts. During this same period, amounts totaling $1,063,000 were subsequently transferred from the bank accounts in the name of International Clearing House and Information Services International to eight numbered bank accounts in the name of Val International of which petitioner possessed signatory authority. Amounts totaling $863,000 were then transferred from the Val International Accounts to three bank accounts in the names of Lark Enterprises, Yellow Rose Properties, and Southern Utilities on which petitioner also possessed signatory authority. The remaining $200,000 in the Val International accounts was used to purchase a certificate of deposit in the name of "Val International Account #8."

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[2] In *Freedson v. Commissioner*, 65 T.C. 333, 335–336 (1975), affd. 565 F.2d 954 (5th Cir. 1978), we held that "Rule 90 of the Rules of this Court contemplates that a party's failure to respond to a request will result automatically in the admission of the statements in the request without the necessity of a confirming order." Accordingly, no confirming order has been made in this case.

For fiscal years ended March 31, 1977, March 31, 1978, March 31, 1979, and March 31, 1980, petitioner filed Forms 1041 (U.S. Fiduciary Income Tax Return) in the name of Trust Publications on which he reported as gross profit the membership fees deposited in the Trust Publications bank accounts. On the 1978, 1979, and 1980 returns, petitioner deducted royalty payments totaling $1,153,100. A substantial portion of these royalty payments consisted of amounts transferred from the Trust Publications bank accounts to the bank accounts in the name of International Clearing House and Information Services International. Petitioner also claimed deductions totaling $59,243.45 for the trustee fees he received.

On their 1977, 1978, and 1979 Federal income tax returns, petitioners reported as income the trustee fees petitioner received from Trust Publications. Petitioners did not report as income the membership fees deposited in the Trust Publications bank accounts.

In the notice of deficiency, respondent determined that Trust Publications was a sham entity having no substance, purpose, or economic reality other than as a vehicle to evade the payment of Federal income taxes. Respondent therefore determined that petitioners are taxable on the membership fees deposited in the Trust Publications bank accounts. Respondent also determined that all or part of the underpayment of tax required to be shown on petitioners' Federal income tax returns for the years in issue was due to fraud.

In their petition filed on July 12, 1983, petitioners disputed respondent's deficiency determination and additions to tax, contending that Trust Publications was not a sham entity, but rather was a valid domestic business trust which was properly taxable on the fees earned from the sale of ALA memberships.

On July 30, 1984, respondent filed a motion for summary judgment based on the facts deemed admitted under Rule 90(c). Petitioners have raised numerous objections to respondent's motion, including an assertion that the facts deemed admitted under Rule 90(c) were based on grand jury materials which the Ninth Circuit had previously ordered respondent to return.

On September 12, 1984, petitioners filed a motion to withdraw admissions and a motion for extension of time to answer requests for admission.

On October 22, 1984, this case was called from the trial calendar of the Court's session at Houston, Texas, and subsequently recalled on October 29, 1984, for hearing on certain motions. Both parties appeared at the hearing and introduced into evidence various documents and affidavits. Petitioners also submitted "answers" to respondent's interrogatories and requests for production of documents consisting of the same objections previously filed by petitioners on September 10, 1984.

By order dated October 29, 1984, we took under advisement petitioners' motion for extension of time to answer requests for admission and petitioners' motion to withdraw admissions. We further ordered that respondent's motion for summary judgment, respondent's motion to compel responses to respondent's interrogatories to petitioners and to compel production of documents or to impose sanctions under Rule 104(c), and petitioners' motion for a protective order were held in abeyance pending further direction of the Court. We now proceed to rule on these motions.

Motion for Extension of Time

Under Rule 90(c), each request for admission is deemed admitted unless an answer is served on the requesting party "within 30 days after service of the request." The Court, in its discretion, may allow a party more than 30 days to respond under Rule 90(c). However, a motion to extend the time to file responses must be made prior to the expiration of 30 days following service of the requests. *Morrison v. Commissioner*, 81 T.C. 644, 646–647 (1983). If no motion is filed within this time period, each request is deemed admitted. *Morrison v. Commissioner, supra* at 647.

In the instant case, respondent's requests for admission were served on petitioners on June 8, 1984. Each request contained therein was therefore deemed admitted on July 9, 1984. Rule 90(c); *Freedson v. Commissioner*, 65 T.C. 333, 334–336 (1975), affd. 565 F.2d 954 (5th Cir. 1978). Consequently, petitioners' motion for extension of time to answer requests for admission filed on September 12, 1984, is untimely and is denied.

Motion To Withdraw Admissions

Under Rule 90(e), an admission may be withdrawn or modified (1) if the withdrawal or modification would subserve the presentation of the merits of the case, and (2) if the party obtaining the admission "fails to satisfy the Court that the withdrawal or modification will prejudice him in prosecuting his case or defense on the merits."

With respect to the first criterion, we do not believe that the withdrawal of the admissions would subserve the presentation of the merits of the case. Petitioners do not object to the accuracy of the admissions establishing the amount of fees received from the sale of ALA memberships and the various trust accounts to which these fees were transferred. Rather, petitioners contest respondent's determination that the various trusts were sham. As discussed *infra*, we have found that the deemed admissions, standing alone, are insufficient to sustain a summary adjudication that petitioners engaged in sham transactions during the years in issue. Petitioners will therefore be given the opportunity to fully litigate respondent's sham argument at trial, even if the admissions are not withdrawn. Consequently, because petitioners have not objected to the accuracy of the facts deemed admitted under Rule 90(c), we do not believe that the withdrawal of the admissions would subserve the presentation of petitioners' case.

Even assuming that petitioners would contest the admitted facts at trial, we would nevertheless deny petitioners' motion, because respondent has satisfied the Court that the withdrawal of the admissions will prejudice him in prosecuting the merits of his case for the following reasons. In *Morrison v. Commissioner, supra* at 649, we stated that "A party will be prejudiced by the withdrawal of admissions if he has relied on them and will suffer delay, added expense, and additional effort because of the withdrawal."

In the instant case, respondent has relied in good faith on the binding effect of the deemed admissions to prepare his motion for summary judgment. Petitioners made no suggestion prior to the time respondent filed his motion for summary judgment that they intended to file a motion to withdraw the deemed admissions. Indeed, petitioners filed their motion to withdraw admissions more than 2 months after respondent's requests were deemed admitted and more than 1 month after respondent filed his motion for summary judgment. Thus, because respondent reasonably relied on petitioners' failure to reply or object to the requested admissions, withdrawal of the deemed admissions would result in an unfair waste of respondent's work on the motion. *Morrison v. Commissioner, supra.*

In addition to having reasonably relied on the deemed admissions, respondent will suffer delay, added expense, and additional effort if he is required to again prove at trial the matters contained in the admissions. The facts deemed admitted establish the amount of proceeds received from the sale of petitioner's tax shelter program and the various bank accounts to which these proceeds were deposited. To prove these facts at trial will require the additional expense and effort of subpoenaing, copying, scheduling, and analyzing numerous bank records. Further, respondent will be forced to identify, locate, and subpoena the purchasers of petitioner's tax shelter program.

The withdrawal of the admissions will also cause further delay in the disposition of this case. Petitioners have repeatedly responded to respondent's discovery requests with frivolous objections and numerous spurious motions. We believe that petitioners will continue to pursue these dilatory tactics if respondent is required to again prove at trial the matters contained in the admissions. Thus, as we found in *Morrison v. Commissioner, supra* at 650, when "we weigh our interest in diligence of litigation and the prejudice to respondent against petitioners' desire for a trial on the merits, the scales fall far on the side of respondent."

Petitioners nevertheless argue that we should grant their motion to withdraw admissions because respondent's requests for admission were based on grand jury materials which the Ninth Circuit ordered respondent to return. Respondent disagrees, contending that the requests for admission were not based on any grand jury materials. Alternatively, respondent argues that even if he had relied on grand jury materials during the period the rule 6(e) order was in effect, such reliance would have been appropriate under *Kluger v. Commissioner*, 83 T.C. 309 (1984). Because we agree that respondent did not rely on grand jury materials to draft his requests for admission, we need not and do not decide whether respondent's reliance on the grand jury materials would have been appropriate in this case.

To support his contention that the requests for admission were not based on grand jury materials, respondent introduced the affidavit of David Johnson (Johnson), the attorney who drafted the requested admissions. In his affidavit, Johnson stated under oath that "No evidence cloaked with grand jury secrecy or grand jury evidence disseminated pursuant to [the rule 6(e) order] was used in drafting * * * Respondent's Request for Admissions." Johnson also prepared and respondent submitted a schedule listing the non-grand-jury sources of each fact and exhibit contained in respondent's requests for admission. Petitioners made no submissions contesting Johnson's statements made under oath or Johnson's representation as to the non-grand-jury source of the facts and exhibits contained in the requests for admission. We are therefore satisfied that respondent did not rely on grand jury materials to draft his requests for admission. Accordingly, petitioners' motion to withdraw admissions is denied.

Motion for Summary Judgment.

Under Rule 121, a summary adjudication may be made "if the pleadings, answers to interrogatories, depositions, admissions, and any other acceptable materials, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that a decision may be rendered as a matter of law." Rule 121(b). The party opposing the motion cannot rest upon the allegations or denials in his pleadings, but must "set forth specific facts showing that there is a genuine issue for trial." Rule 121(d). The moving party, however, bears the burden of proving that there is no genuine issue of material fact, and factual inferences will be read in a manner most favorable to the party opposing summary judgment. *Jacklin v. Commissioner*, 79 T.C. 340, 344 (1982); *Espinoza v. Commissioner*, 78 T.C. 412, 416 (1982).

Respondent contends that all relevant facts have been admitted under Rule 90(c) and are sufficient to establish that petitioner "engaged in an elaborate deceptive scheme using numerous nominee trust bank accounts to conceal large amounts of income on which he evaded payment of the income tax due thereon." We cannot agree that petitioners are to be thus foreclosed from offering at a subsequent trial additional evidence they may deem sufficient to place the admitted facts in a different light, although they will not, of course, be permitted to attempt to impeach the facts they have already admitted.

The facts deemed admitted under Rule 90(c) establish the amount of fees received from the sale of ALA memberships and the various trust accounts into which these fees were deposited. The record, however, contains no additional evidence supporting respondent's contention that these trusts were sham or that petitioner engaged in transactions with these trusts to conceal large amounts of income. Indeed, if anything, the record establishes that petitioner accurately and fully disclosed all fees earned from the sale of ALA memberships on the Forms 1041 filed in the name of Trust Publications. Thus, because respondent fails to point to any admitted facts which without further evidence establish that the trusts, and petitioner's transactions involving the trusts, were sham, we must deny respondent's motion for summary judgment.

Respondent maintains, however, that petitioners are deemed to have admitted under Rule 90(c) "There are due from the petitioners the deficiencies in income tax and additions to tax as determined by respondent." While we have held in a different context that undenied allegations of fact stated in conclusory language will support imposition of the addition to tax for fraud under section 6653(b), the undenied conclusory allegations were preceded and supported by undenied allegations of specific facts which were consistent with the conclusory allegations of fraud. See *Doncaster v. Commis-*

sioner, 77 T.C. 334, 337 (1981). To the contrary, as we have pointed out here, the admitted detailed facts do not, standing alone, support respondent's sham theory, and petitioners (who nevertheless have the burden of proof under Rule 142(a)) will have the opportunity at trial to introduce further evidence to disprove the sham allegations.[3] Since the admitted facts do not alone establish sham, they do not in and of themselves support the conclusory facts upon which respondent also relies for summary judgment. For the purposes of these motions we therefore relieve petitioners of the effect of the deemed admission that "there are due from the petitioners the deficiencies in income tax and additions to tax as determined by respondent." This specific request for admissions will be deemed denied.

Motion To Compel Responses to Respondent's Interrogatories to Petitioners and To Compel the Production of Documents or To Impose Sanctions Under Rule 104(c)

Under Rule 71, "Any party may, without leave of Court, serve upon any other party written interrogatories to be answered by the party served." Rule 72 provides:

> (a) Scope: Any party may, without leave of Court, serve on any other party a request to:
>
> (1) Produce and permit the party making the request * * * to inspect and copy, any designated documents * * * to the extent that [they] * * * are in the possession, custody or control of the party on whom the request is served; * * *

Petitioners do not contend that respondent's discovery requests deal with items not in their possession, custody, or control. Rather, petitioners' principal objection to these requests is that they are based on grand jury materials which the Ninth Circuit ordered respondent to return. The record, however, does not support petitioners' contention.

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[3] In *Falsetti v. Commissioner*, 85 T.C. 332, 347 (1985), we defined "sham in substance" as "the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits." Thus, at the trial of this case, petitioners will be given the opportunity to prove that the transactions were consistent with the objective economic realities or had economic significance beyond the expected tax benefits.

David Johnson, in addition to drafting respondent's requests for admission as previously discussed, also drafted respondent's interrogatories to petitioners and respondent's request for production of documents. Johnson stated in affidavit under oath that "No evidence cloaked with grand jury secrecy or grand jury evidence disseminated pursuant to [the rule 6(e) order] was used in drafting * * * Respondent's Request for Production of Documents, the Respondent's Interrogatories to Petitioners." Johnson also prepared a schedule listing the non-grand-jury sources of information and evidence used to draft the request for production of documents and interrogatories to petitioners. Petitioners made no submissions contesting Johnson's statements made under oath to Johnson's representation as to the source of the information contained in the request for production of documents or the interrogatories. We therefore are satisfied that respondent did not rely on grand jury materials to draft his request for production of documents or his interrogatories to petitioners.

We have considered petitioners' other objections and find them equally unpersuasive. Accordingly, respondent's motion to compel responses to respondent's interrogatories to petitioners and to compel production of documents or to impose sanctions under Rule 104(c) is granted. Petitioners will be required to respond fully and completely within the time limitations provided in the accompanying orders.

Petitioners' Motion for a Protective Order

On September 11, 1984, petitioners filed a motion for a protective order requesting the Court to limit respondent's discovery to taxable year 1979. To support their motion, petitioners principally argue that (1) respondent's discovery requests were for the purpose of annoyance, embarrassment, oppression, and undue burden of expense, and (2) the statute of limitations has expired for taxable years 1977 and 1978.

With respect to the first contention, petitioners offered no evidence that respondent's discovery requests were for the purpose of annoyance, embarrassment, oppression, or undue burden or expense. Indeed, we find respondent's discovery requests very relevant to the issues in dispute. Moreover, respondent has requested information which is in petitioners' possession, custody, or control and can be obtained with no undue burden or expense.

We are also unpersuaded by petitioners' contention that the statute of limitations has run on taxable years 1977 and 1978. Under section 6501(c)(1), the statute of limitations does not run on a fraudulent return. Respondent has alleged in the notice of deficiency and answer to petition that some part of the underpayment of tax for 1977 and 1978 was due to fraud. If we were to ultimately decide in favor of respondent on this issue, the statute of limitations would not have run on the tax deficiencies for 1977 and 1978. Consequently, taxable years 1977 and 1978 remain in issue at this time.

Accordingly, petitioners' motion for a protective order will be denied.

Appropriate orders will be issued.

SOL LESSINGER AND EDITH LESSINGER, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 24103-81. Filed November 20, 1985.

Petitioner husband transferred the assets and related business liabilities of his sole proprietorship to his pre-existing wholly owned corporation. No additional stock or securities were issued to petitioner. *Held*: The exchange requirements of sec. 351, I.R.C. 1954, are met. To the extent that *Abegg v. Commissioner*, 50 T.C. 145 (1968), affd. on different grounds 429 F.2d 1209 (2d Cir. 1970), is inconsistent in this regard, it is overruled. *Held, further*, the liabilities assumed by the corporation are in excess of the adjusted basis of the transferred assets and, therefore, gain is recognized under sec. 357(c) to the extent of the excess. *Held, further*, the innocent spouse provisions under sec. 6013(e) are inapplicable.

Bruno Schachner, for the petitioners.

William Gross, *Arnold Gould*, and *Robert L. Schneps* for the respondent.

CLAPP, *Judge*: Respondent determined deficiencies in petitioners' Federal income tax in the amounts of $114,147.30 and $1,427.50 for the taxable years 1977 and 1978, respectively.

After concessions, the issues remaining for decision are: (1) Whether petitioner Sol Lessinger should recognize gain of $251,014, in the taxable year 1977 pursuant to section 357(c);[1] and (2) whether petitioner Edith Lessinger is entitled to relief from liability for the 1977 deficiency under the provisions of section 6013(e).

FINDINGS OF FACT

Some of the facts have been stipulated and are found accordingly.

Petitioners Sol and Edith Lessinger, husband and wife, resided at Suffern, New York, on the date the petition in this case was filed. Petitioners filed joint Federal income tax returns for the taxable years 1977 and 1978, the years before the Court.

For over 25 years prior to December 31, 1976, petitioner Sol Lessinger (hereinafter petitioner in the singular) was engaged in business as a sole proprietor using the trade name Universal Screw & Bolt Co. (hereinafter proprietorship). The proprietorship acted as a wholesale distributor of a variety of metal fasteners. Universal Screw & Bolt Co., Inc., a New York corporation (hereinafter Universal), was organized on January 1, 1962. Petitioner has been the sole shareholder of Universal since it was incorporated. Universal was engaged in a similar business as the proprietorship, that is, the wholesale distribution of a variety of metal fasteners. Petitioner was the president and chief executive officer of Universal.

The business operations of Universal and the proprietorship were conducted from the same location on Ninth Avenue, New York, New York. Prior to January 1, 1977, Universal and the proprietorship carried on separate business operations and maintained separate books and records. Both maintained their books and records and filed their Federal income tax returns using the accrual basis of accounting and the calendar year accounting period.

The proprietorship's working capital was provided in part by a factor which made loans secured by a pledge of the proprietorship's accounts receivable. In the latter part of 1976, the factor refused to continue the existing arrangement. It notified petitioner, through S.Z. Swidler, petitioner's attorney and accountant, that it would continue the financing only for a corporation so that the factor could take advantage of the higher interest rate permitted on loans to corporations under the laws of the State of New York. Petitioner instructed Mr. Swidler to do whatever was necessary for the proprietorship to become a corporation so that he could continue operation. The details of the transfer were not explained to petitioner. Mr. Swidler instructed his associate, Nathan Kutner, a certified public accountant, and Max Fuchs, the bookkeeper of the proprietorship, as to the necessary arrangements for the transfer. It was determined that the businesses operated by the proprietorship and Universal should be consolidated as of January 1, 1977.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

The unaudited balance sheet of the proprietorship as of December 31, 1976, disclosed the following:

ASSETS

Current assets:		
Cash in bank and on hand	$3,915.80	
Accounts receivable	424,880.51	
Marketable securities and mutual funds	266,603.93	
Merchandise inventory	885,419.00	
Total current assets		$1,580,819.24
Fixed assets:		
Furniture and fixtures	74,211.66	
Equipment	9,953.69	
Automobiles and trucks	51,915.87	
Office machines	13,648.30	
Improvements	33,328.75	
Total	183,058.27	
Less accumulated depreciation	77,432.48	
Total fixed assets		105,625.79
Other assets:		
Investment - Israeli bonds	1,330.00	
Goodwill	40,000.00	
Programming - net	1,070.00	
Prepaid expenses	3,300.03	
Total other assets		45,700.03
Total assets		1,732,145.06

LIABILITIES AND CAPITAL

Current liabilities:		
Accounts payable - trade	$416,026.24	
Notes payable - due within 1 year	990,795.02	
Due to broker	329.15	
Taxes payable	6,735.55	
Loans and exchanges	5,022.91	
Accrued expenses	161,807.97	
Total current liabilities		$1,580,716.84
Other liabilities:		
Notes payable - due after 1 year		341,822.81
Capital:		
Sol Lessinger - Capital (Exhibit "B")		(190,394.59)
Total liabilities and capital		1,732,145.06

Schedule A-1

	Due within 1 year	*Due after 1 year*
Notes payable:		
Chemical Bank	$202,500.00	$337,786.47
Trade	464,288.62	4,036.34
Auto loans	8,727.51	- - -
Insurance	278.89	- - -
Trefoil	315,000.00	- - -
Total notes payable	990,795.02	341,822.81

On January 1, 1977, the proprietorship bank account was closed and all business activity formerly conducted by the proprietorship was carried on by Universal. On that date, the operating assets and related business liabilities of the proprietorship were transferred to the pre-existing corporation, Universal. The principal assets which were not transferred were mutual fund shares. The principal liability not transferred was the loan from Chemical Bank secured by the mutual fund shares.

No shares of stock or other securities were issued by Universal. No written agreements were prepared or executed between Universal and petitioner in connection with the consolidation.

Certain liabilities of the proprietorship were expressly assumed by Universal: (1) The indebtedness to the factor Trefoil, and (2) the trade notes payable in the amount of $802,075.09. These notes payable are of two types. First, the proprietorship had issued notes to creditors which were payable after January 1, 1977, at the bank of the proprietorship. After January 1, 1977, and prior to the due date, each payee was notified to change the name of the maker of the note to Universal and the place of payment to Universal's bank. The physical change was accomplished either by an employee of Universal or an employee of the payee. Second, in or about the month of December 1976, it had already been decided that the proprietorship would discontinue its business and bank account. Notes given for debts incurred by the proprietorship during that period, but which were not to become due until after January 1, 1977, designated Universal as payor, and were made payable at Universal's bank.

The trade accounts payable were not discussed with the creditors. The creditors of the proprietorship were the same as those of the corporation. It was intended that Universal would pay these accounts and in fact it did so within 3 to 6 months after the consolidation. The accounts payable ledger of the sole proprietorship was used as the corporate record.

Five months after the consolidation on June 1, 1977, the following journal entries were made to reflect the consolidation:

Cash in bank	$3,715.80	
Petty cash	200.00	
Accounts receivable - N.Y	363,359.22	
Accounts receivable - Phila	61,521.29	
Furniture and fixtures	74,211.66	
Equipment	9,953.69	
Autos and trucks	51,915.87	
Office machines	13,648.30	
Improvements	33,328.75	
Goodwill	40,000.00	
Programming	2,675.00	
Prepaid - insurance	2,057.09	
Prepaid - interest	1,242.94	
Inventory	885,419.00	
Loan receivable - SL	255,499.37	
Accumulated depreciation—		
F. & F.		$26,149.70
Equipment		4,159.82
Autos		33,813.99
Office machines		5,507.19
Improvements		7,801.78
Programming		1,605.00
Loan and exchange		5,022.91
Accounts payable - trade		416,026.24

Accounts payable - expenses	$27,479.09
Notes payable - trade	802,075.09
Notes payable - equipment	13,042.74
Notes payable - Trefoil	315,000.00
Payroll taxes payable	6,735.55
Commissions payable	6,376.12
Accrued expenses	127,952.76

The amount that the liabilities of the proprietorship exceeded the adjusted basis of the assets is represented by the notation "Loan receivable - SL" (SL represents petitioner) of $255,499.37. This amount was in turn posted in June 1977 on a general ledger sheet as a debit to petitioner's account. Petitioner did not execute a note for this amount nor did he pay or agree to pay any interest on this amount. A non-business debt of $3,500 owed by petitioner was paid by Universal at the time of the consolidation and was charged to petitioner's account. During January 1977, petitioner sold his mutual funds. The net proceeds of the sale were used to pay down the Chemical Bank Loan, and a balance of $62,209.35 was paid to Universal. This payment was credited on Universal's books to petitioner's account. After these entries were posted, petitioner's account showed a debit in the amount of $196,790. No part of this amount was paid to Universal through the end of 1982. Petitioner's account at the end of 1982 showed a balance of $237,044. In October 1981, petitioner executed a note for the balance in his account at the request of a creditor.

At the beginning of 1977, Universal had retained earnings of $29,638; at the end of 1977, $38,671. Petitioner's basis in the stock of Universal was $500 at all times material hereto.

Petitioners Sol and Edith were married in 1940. Although not legally separated or divorced, they have lived apart since 1971. Mrs. Lessinger was listed as an employee on Universal's payroll and received a salary from Universal which was reflected on Forms W-2 issued by Universal. Mrs. Lessinger did not perform any service for Universal and did not discuss any business with petitioner. Mrs. Lessinger was aware that the weekly checks she received for approximately $300 came from either the proprietorship or Universal and that the checks were net of payroll deductions.

The Commissioner determined in the notice of deficiency issued to petitioners, that petitioners had recognized gain in the amount of $251,014 under section 357(c). The amount of

$255,499 shown on Universal's books as the excess of the liabilities over the adjusted basis of the transferred assets was reduced by the Commissioner in the amount of $4,485 to reflect changes in the adjusted basis of certain of the assets. This adjustment is not disputed nor is the character of gain (89.78-percent ordinary income and 10.22 percent of capital gain), if any gain is recognized under section 357(c).

OPINION

Section 357(c)[2] is applicable to the subject transaction only if there is an exchange to which section 351[3] applies. Here, the question is whether section 351 applies to the transfer of the proprietorship's assets and liabilities to petitioner's wholly owned corporation, even though petitioner received no additional stock or securities from the corporation. Petitioners argue that section 351 by its own terms applies only to exchanges for stock or securities. Petitioners concede that the failure to issue stock may be disregarded in the case of a wholly owned corporation if the transaction could otherwise be a device to evade taxes, but here there was no such attempt because there is nonexistent economic gain. Petitioners argue that the best way to view the subject transaction, taking into account the value of petitioner's debt to the corporation, is as a contribution to capital of zero value. Respondent argues that the failure to issue stock should not preclude the application of section 351, inasmuch as the issuance of stock where property is transferred by a 100-percent shareholder is a meaningless gesture.

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[2] SEC. 357. ASSUMPTION OF LIABILITY.

(c) LIABILITIES IN EXCESS OF BASIS.—

(1) IN GENERAL.—In the case of an exchange—

(A) to which section 351 applies, or

(B) to which section 361 applies by reason of a plan of reorganization within the meaning of section 368(a)(1)(D),

if the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be.

[3] SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

The view that an exchange of stock is a meaningless gesture where the proportionate ownership of the transferor and transferee is identical has been adopted by this Court and others in the context of determining whether a liquidation and subsequent reincorporation of corporate assets is in actuality a reorganization. In *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961), revg. 33 T.C. 30 (1959), the taxpayer was the sole shareholder of the transferor and the transferee corporations. The transferor was liquidated and the operating assets were conveyed to the transferee who performed identical services as the transferor. Cash and bonds were distributed from the transferor to the taxpayer who reported the distribution as a distribution in liquidation and treated the gain as long-term capital gain. The Commissioner determined that the distribution was taxable as dividend income under the pertinent reorganization provisions of the Internal Revenue Code of 1939. The Third Circuit agreed and found the stock exchange requirements of section 112(b)(3) and (c) (corresponding to section 354(a)(1) and section 356(a)(1)(B) of the Internal Revenue Code of 1954) had been satisfied. The court then stated:

> If the transferor's assets had been transferred to a newly formed corporation in exchange for stock, there is no question that the boot would have been taxable as dividend income. That an existing corporation in which the taxpayer was the sole shareholder was used instead of a newly formed one cannot alter the true nature of the transaction. Here, the issuance of new stock would have been a meaningless gesture since the stock the taxpayer already held represented the total value of all the assets except for the boot. [288 F.2d at 680.]

This Court followed this reasoning in an analogous case, *James Armour, Inc. v. Commissioner*, 43 T.C. 295, 307 (1964), where two individuals were sole shareholders of the transferor corporation, Armour, Inc., and the transferee corporation, Excavating. The transferor corporation liquidated and its operating assets were conveyed to the transferee. The issue presented was whether a complete liquidation of Armour, Inc., had occurred or a reorganization under section 368(a)(1)(D). In answer to taxpayers' argument that the stock exchange requirements of section 354, section 355, or section 356 had not been met because no stock of the transferee was actually distributed to the transferor or the shareholders, this Court stated:

> the petitioners already owned all the stock of Excavating and it was not necessary that further stock be issued in order that they might retain their same proprietary interest in the assets received by Excavating. The issuance of further stock would have been a meaningless gesture, and we cannot conclude that the statute requires such a vain act. We conclude, therefore, that there was in substance an exchange of stock of Armour, Inc., for stock of Excavating, which meets the requirements of sections 354 and 356 of the Code. * * * [43 T.C. at 307.]

The Court expressed the view that the holding in *Morgan*:

> was not based upon the reasoning that in effect stock of the transferee corporation was issued to the transferor corporation in exchange for any assets transferred without consideration. Rather, we construe that case as holding that the exchange requirements are met if, when a series of transactions is completed, the stockholders of the old corporation retain their proprietary interest in the same going business, although in another corporate shell. * * * [43 T.C. at 308.]

This principle, that the actual distribution of stock would be a mere formality when ownership of the transferor and the transferee is identical, has been applied repeatedly. *Atlas Tool Co. v. Commissioner*, 70 T.C. 86, 97 (1978), affd. 614 F.2d 860, 865 (3d Cir. 1980); *American Mfg. Co. v. Commissioner*, 55 T.C. 204, 221 (1970); *South Texas Rice Warehouse Co. v. Commissioner*, 43 T.C. 540, 569 (1965), affd. on this issue sub nom. *Davant v. Commissioner*, 366 F.2d 874, 886–887 (5th Cir. 1966). See also *Rose v. United States*, 640 F.2d 1030, 1034 (9th Cir. 1981).

In a case involving a predecessor of section 351, *King v. United States*, 79 F.2d 453 (4th Cir. 1935), affg. 10 F. Supp. 206 (D. Md. 1935), the same reasoning was applied. In *King*, Emile Berliner who owned stock in both an American corporation and a British corporation organized Gramaphone & Securities Corp., a Virginia corporation, in July 1921 and transferred his shares in the British corporation to the new corporation in exchange for substantially all of the stock of the new corporation. Two additional shares were issued for cash. Within 30 days, he also transferred shares in the American corporation to the new corporation without additional stock issuance or other consideration. The delay in the transfer of the American shares was by accident, not design, because the certificate for the shares was not readily available. Gramaphone sold the American stock in 1927. The issue presented in the case was what was the basis of the shares sold. The Service argued that the contributed stock was either a gift or an acquisition of property within the meaning of section 204(a)(8) of the Revenue Act of 1926, 44 Stat. (Part 2) 9, 15 (predecessor to section 351), and therefore the basis was that of the transferor. The taxpayer argued that the contributed stock was paid-in surplus and, therefore, would not come within any of the provisions of the Revenue Act calling for a carryover basis.

The District Court was of the opinion that the transfer fell within the provisions of section 204(a)(8), even though no additional stock was issued. The court stated:

> Here we have in substance a one man corporation where the issuance of additional stock would be of little or no financial substance. It made no material difference to the stockholder whether additional shares of stock were issued or not as the value of all the stock held by him would remain substantially the same irrespective of the mere number of shares. * * * [10 F. Supp. at 209.]

The court believed that this was particularly the case where it was inferable that Berliner originally contemplated transferring both stocks to the corporation and that the stock issued to him by the new corporation was intended to be for both of the contributed stocks.

The Court of Appeals agreed with this inference and agreed with the reasoning of the trial court below that:

> the issuance of additional stock in the transferee corporation to the man who already owned all of the stock would in no way have affected the value of the stock already held by him, while owned by him, and the conclusion is inescapable that the transaction must be treated in substance as the issuance of securities for property transferred. * * * [79 F.2d at 456.]

Both courts referred to the legislative history of the statute involved, as well as the enactment (subsequent to the taxable year involved in the case) of section 113(a)(8) of the Revenue Act of 1932, 47 Stat. 169, 200 (predecessor of section 362(a) of the 1954 Code), to support the view that Congress intended to impose a tax on the appreciated value of stock from March 1, 1913, to the date when sold. Under section 113(a)(8) of the Revenue Act of 1932 and section 362(a) of the 1954 Code, Congress explicitly provided that when there is a contribution to capital there is a carryover basis.

Contrary to this view that formal distribution of stock is not required is the case of *Abegg v. Commissioner*, 50 T.C. 145 (1968), affd. on other grounds 429 F.2d 1209 (2d Cir. 1970). The issue to be decided there was whether section 367,[4] as then enacted, applied so that gain would be recognized on a contribution of securities by a nonresident alien to his wholly owned foreign corporation. Section 367 was not applicable unless the contribution was considered a section 351 exchange. The taxpayer, Werner Abegg, was a Swiss citizen who had contributed various stocks to his wholly owned Panamanian corporation, Cresta. Two of the stocks had appreciated in value and one had depreciated in value. The net value of the three stocks was less than their aggregate bases. The Commissioner had determined that the transfer of stocks was in effect an exchange under section 351 and, accordingly, section 367 was applicable. Because no advance ruling was obtained on the transfer, the Commissioner determined that the gain on the two stocks should be recognized. Respondent relied on the cases of *King v. Commissioner, supra*, and *Morgan v. Commissioner, supra*, to support his position that the issuance of additional stock of Cresta was immaterial to the determination that section 351 was applicable.

This Court distinguished the two cases—*Morgan* because it involved a question of a reorganization, and *King* because it involved a question of basis. Unlike *King*, the transfer by Abegg of the securities could not be considered in any way as part of the original incorporation. This Court found that no exchange as provided by section 351 had taken place. Therefore, it was held that the securities transferred constituted a contribution to capital and that section 351 and, therefore, section 367 were inapplicable.

The Court of Appeals affirmed this result but on different grounds. The appellate court reasoned that contributions to capital by U.S. citizens or residents to foreign corporations for purposes of avoidance of Federal income taxes were expressly covered by the 1932 Congress in section 901 of the Revenue Act of 1932, 47 Stat. 169, 284 (carried forward as section 1491 in the 1954 Code), which imposed a 25-percent excise tax. If the combination of section 112(k), 47 Stat. 198 (predecessor of section 367) and section 112(b)(5), 47 Stat. 196 (predecessor of section 351), reached a contribution to capital, then section 901 was unnecessary. The court further stated:

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[4] Sec. 367 as in effect for taxable year 1958 provided as follows:

In determining the extent to which gain shall be recognized in the case of any of the exchanges described in section 332, 351, 354, 355, 356, or 361, a foreign corporation shall not be considered as a corporation unless, before such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

> But it would be anomalous to hold that although the combination of § 112(k) and § 112(b)(5) of the 1932 Act, now I.R.C. § 351, did not reach the important subject of contributions of appreciated assets to capital or paid-in surplus by a United States citizen to a foreign corporation, which Congress felt obliged to cover separately in § 901, it did reach contributions of such assets as capital or paid-in surplus by nonresident aliens. While the alternative, *distinguishing among transfers by nonresident aliens to wholly-owned foreign corporations on the basis of whether they take stock back, is* also *anomalous*, it is less so. Indeed, the real anomaly may be in a nonresident alien's being caught in the net at all, when he could have avoided the problem altogether by selling the securities abroad and transferring the proceeds. * * * [429 F.2d at 1217. Emphasis added.]

While the Second Circuit affirmed the result of this Court, it characterized the rationale as emphasized above as anomalous. The present case also arises in the Second Circuit. Under *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), affd. 445 F.2d 985 (10th Cir. 1971), we will follow a Court of Appeals decision which is squarely on point. However, the present case is not squarely on point because it does not involve a question of the applicability of section 367. Nevertheless, we believe that a reconsideration of this Court's finding in *Abegg* is warranted insofar as it relates to the exchange requirement in section 351.

The concern in *Abegg* was the application of section 367 to the transfer by a nonresident alien to his wholly owned corporation. Under these circumstances, this Court did not wish to extend the rationale of the *Morgan* and *King* cases so as to apply section 367 to such a transfer.[5] While *King* may be distinguished because of the contemporaneous nature of the transfers and the emphasis placed on the legislative history of the basis provisions, the reasoning used by both the District Court and appellate court that the issuance of stock is meaningless where there is a wholly owned corporation is still sound. In *Morgan*, the issue was whether a reorganization had occurred. To qualify as a reorganization, the stock exchange requirements under section 112(b)(3) and (c) of the Internal Revenue Code of 1939 (corresponding to section 354(a)(1) and 356(a)(1)(B) of the 1954 Code) had to be satisfied. The court held that the exchange requirements had been met because the issuance of stock would have been a meaningless gesture where the corporation is already wholly owned. We can see no reason to interpret the phrase "exchange" differently under sections 354 and 356 than under section 351. Here, whether petitioner issued additional stock could make no difference, he still owned 100 percent of the corporation. Accordingly, we believe that the requirements of section 351 are met in the subject transfer of assets and liabilities to petitioner's wholly owned corporation, even though no additional stock was issued. To the extent that *Abegg* is inconsistent in this regard, it is overruled.

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[5] Sec. 367 had been subsequently amended to provide that contributions of capital by controlling shareholders are to be treated as an exchange. In addition, the provisions of sec. 367 have been substantially altered so that they would not apply to a transfer by a nonresident alien of property to his wholly owned foreign corporation under the circumstances in *Abegg v. Commissioner*, 50 T.C. 145 (1968), affd. on different grounds 429 F.2d 1209 (2d Cir. 1970). Sec. 367(a) and sec. 367(b) and the regulations promulgated thereunder.

The next question is whether section 357(c) is applicable. Petitioners contend that the corporation, Universal, did not assume all the proprietorship's liabilities, in particular, the trade accounts payable. Their argument is that petitioner retained personal liability and that the corporation merely lent the funds to petitioner to pay the accounts.

Whether the corporation assumed the liabilities is a question of State law.[6] Under New York law, an express act of authorization is normally essential to corporate responsibility for preincorporation obligations. However, an exception to this rule is recognized where the same person is doing business in the corporate form and the corporation is simply the alter ego of the prior business. *Reif v. Williams Sportswear, Inc.*, 9 N.Y. 2d 387, 392, 214 N.Y.S. 2d 395, 399 (1961); *Joyce Research & Development Corporation v. Equi-Flow Division of Vibro Mfg. Co.*, 31 Misc. 2d 952, 221 N.Y.S.2d 164 (1961), affd. 15 App. Div. 2d 821 (1962), appeal dismissed 11 N.Y.2d 1011 (1962). No proof of fraudulent intent is required. *Woodland Nursing Home Corp. v. Harris*, 514 F. Supp. 110 (S.D. N.Y. 1981), affd. without published opinion sub nom. *Woodland Nursing Home Corp. v. Schweiker*, 697 F.2d 302 (2d Cir. 1982).

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[6] See *Beaver v. Commissioner*, T.C. Memo. 1980-429.

The liabilities in dispute in this case arose from the proprietorship's business. The corporation did in fact pay the liabilities. The record is clear that petitioner intended that the corporation should pay the liabilities in the normal course of business. A debt may be considered a section 357(c) liability, even though petitioner retains personal liability. *Smith v. Commissioner*, 84 T.C. 889, 909 (1985); *Rosen v. Commissioner*, 62 T.C. 11, 19 (1974), affd. without published opinion 515 F.2d 507 (3d Cir. 1975).[7]

Even the journal entries made some months after the transfer reflect that the liabilities were assumed by the corporation. The notation, "loan-receivable-SL" merely represents the excess of the liabilities over the adjusted basis. No note was executed by petitioner at the time for this amount nor was any interest paid. Even if petitioner had executed a note, it would have a zero basis in the hands of the corporation. *Alderman v. Commissioner*, 55 T.C. 662 (1971).[8] Therefore, we conclude that petitioners must recognize gain pursuant to section 357(c).

Petitioners contend that Edith is not liable for the deficiency attributable to the section 357(c) gain for taxable year 1977 under the provisions of section 6013(e). Section 6013(e), as amended by the Tax Reform Act of 1984 (Pub. L. 98–369, sec. 424(a), 98 Stat. 494, 801–802), was made retroactively applicable to all pending cases and provides in relevant part as follows:

> SEC. 6013(e). Spouse Relieved by Liability in Certain Cases.—
>
> (1) In general.—Under regulations prescribed by the Secretary, if—
>
> (A) a joint return has been made under this section for a taxable year,
>
> (B) on such return there is a substantial understatement of tax attributable to grossly erroneous items of one spouse,

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[7] See also *Beaver v. Commissioner, supra*. Compare *Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir. 1983), affg. in part, revg. in part, and remanding a Memorandum Opinion of this Court, where it was found that the corporation did not assume taxpayer's liability on the loans.

[8] See also *Christopher v. Commissioner*, T.C. Memo. 1984–394, where such a notation was characterized as an artificial receivable and was not a bona fide asset of the corporation.

> (C) the other spouse establishes that in signing the return he or she did not know, and had no reason to know, that there was such substantial understatement, and
>
> (D) taking into account all the facts and circumstances, it is inequitable to hold the other spouse liable for the deficiency in tax for such taxable year attributable to such substantial understatment, then the other spouse shall be relieved of liability for tax (including interest, penalties, and other amounts) for such taxable year to the extent such liability is attributable to such substantial understatement.

Petitioners argue that Edith did not know and had no reason to know that there was a substantial understatement. Petitioners further argue that it would be inequitable to hold Edith liable under the facts and circumstances of this case.

Petitioners have the burden of proving that Edith is entitled to relief and meets all the requirements of section 6013(e). *Sonnenborn v. Commissioner*, 57 T.C. 373, 381–383 (1971). While the record is clear that Edith did not know of the understatement, it is by no means clear that she had no reason to know. No evidence was introduced that she was prevented from ascertaining the facts about the joint return she was signing. The testimony of Edith reveals that she had no interest in knowing the details, and she did not ask any questions when she began receiving checks from Universal.

More to the point, however, is the requirement that it is inequitable to hold Edith liable for the deficiency. We believe that the case of *McCoy v. Commissioner*, 57 T.C. 732 (1972), is dispositive of this issue. In that case, the deficiency was also attributable to the omission of gain recognized under section 357(c) upon the incorporation of the proprietorship of the petitioner's husband. The Court stated:

> the omission here resulted not from any concealment, overreaching, or any other wrongdoing on behalf of the husband, though we appreciate that the "innocent spouse" provisions do not specifically require wrongdoing in order to be brought into play. The omission resulted from a misapprehension of the income tax laws by the preparers of the tax returns and the signatory parties. Apparently neither the husband nor the wife knew the tax consequences of the forgiveness of indebtedness here involved. They were in this respect both "innocent spouses" and we perceive no inequity in holding them both to joint and separate liability. [57 T.C. at 735.]

The foregoing language is equally applicable here. See also *Smith v. Commissioner*, 70 T.C. 651, 673 (1978). Therefore, we find that Edith is not entitled to relief pursuant to section 6013(e).

To reflect concessions,

Decision will be entered under Rule 155.

Reviewed by the Court.

Sterrett, Simpson, Goffe, Wilbur, Chabot, Nims, Parker, Whitaker, Körner, Shields, Hamblen, Cohen, Swift, Gerber, and Wright, *JJ.*, agree with this opinion.

Jacobs, *J.*, did not participate in the consideration of this case.

Pleasanton Gravel Co., Successor in Interest to Rio Gravel, Inc., Petitioner *v.* Commissioner of Internal Revenue, Respondent

Docket No. 22723–81. Filed November 25, 1985.

Upon the facts, *held*:

1. Payments received by a corporation which merged into P constituted royalties and are includable in personal holding company income under sec. 543(a)(3) I.R.C. 1954, rather than being rents excludable under sec. 543(a)(6).

2. Waivers executed by P, as successor in interest to a corporation which merged into P, validly extended the period of limitation on assessment and collection of deficiencies owed by the merged corporation.

Dan L. Shehi, for the petitioner.

Thomas M. Rohall, for the respondent.

Körner, *Judge*: Respondent determined deficiencies in Federal income tax against Pleasanton Gravel Co., Successor in Interest to Rio Gravel, Inc. (hereinafter petitioner), as follows:

Tax year ended	*Deficiency*
July 31, 1968	$6,588
July 31, 1969	13,498
July 31, 1970	12,700
July 31, 1971	17,233
June 30, 1972	20,616

After concessions, the issues remaining for decision are: (1) Whether, for the taxable years ended July 31, 1968, through June 30, 1972, Rio Gravel, Inc., a corporation which was merged into petitioner, was a personal holding company subject to the personal holding company tax imposed by section 541;[1] and (2) whether respondent is barred from the assessment and collection of the deficiencies herein, due to the expiration of the applicable period of limitation.

This case was submitted to the Court under the provisions of Rule 122, upon a set of stipulated facts and exhibits. The stipulation of facts and joint exhibits attached thereto are incorporated herein by this reference and form the basis of our findings of fact.

FINDINGS OF FACT

At the time of filing its petition, petitioner was a California corporation with its principal office in Pleasanton, California. At all times herein pertinent, the stock of petitioner was owned by its president, George W. Jamieson. Rio Gravel, Inc. (hereinafter Rio Gravel), was a California corporation, the stock of which at all times herein relevant was owned by Jamieson Co., a partnership consisting of George W. Jamieson and George G. Jamieson. George G. Jamieson died on February 5, 1971, and his interest in Jamieson Co. was subsequently purchased by George W. Jamieson, who continued the business as a sole proprietorship. Thus, in effect, after the death of George G. Jamieson, the stock of Rio Gravel, as well as the stock of petitioner, was all owned by George W. Jamieson.

On January 1, 1959, Rio Gravel entered into an agreement[2] with Jamieson Co. concerning the removal of sand and gravel deposits from land owned by Rio Gravel. By this agreement Rio Gravel purported to "sell and grant to Buyer [Jamieson Co.] forever, all the rock, sand and gravel deposits in, on and under" property situated in the Township of Washington, in

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

[2] We note that the agreement between Rio Gravel and Jamieson Co. was not signed. We find, however, that the parties intended to enter the agreement, intended to sign it, and that the record indicates that the parties acted in accordance with the terms of the agreement. Furthermore, the validity of the agreement is not in issue

Alameda County, California. Pertinent terms and conditions of the agreement were as follows:

> 1. Buyer shall have the right to operate upon the premises described in "Exhibit A" hereto such number of gravel pits and quarries as may be proper under approved quarrying procedures and to excavate and remove from the said premises such rock, sand and gravel as may be proper and profitable under good quarrying practices. * * *
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> * * * * * * *
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> 3. The Buyer shall pay to Seller for every ton of rock, sand or gravel removed by Buyer ten cents (.10¢) for each ton so removed until Buyer shall have removed three million tons. After Buyer has removed three million tons, the price to be paid by Buyer for each ton so removed will depend upon the average wholesale price in Washington Township, County of Alameda, State of California, during the month of removal for the materials so removed, but in no event shall Buyer pay less than five cents (.05 a ton for each ton of rock, gravel or sand removed from the premises described in "Exhibit A." Attached hereto as "Exhibit B" is a schedule setting forth the price that will be payable by Buyer for each ton of rock, gravel or sand removed in excess of three million tons (Column III) based on the base wholesale price per ton in Washington Township, County of Alameda, State of California, for rock and gravel (Column II) or sand (Column I).
>
> Buyer shall deliver to Seller a report in writing showing the number of tons of gravel, rock and sand removed from said premises during the preceding month on or before the 15th day of the calendar month next succeeding the calendar month in which Buyer makes its first removal of gravel, rock or sand from said premises and shall deliver to Seller a like report on or before the 15th day of each calendar month thereafter that Buyer is conducting quarry operations on the premises, and Buyer shall pay to Seller a sum equal to the total purchase price for all gravel, rock and sand as shown in the report due on the 15th day of the preceding month.
>
> 4. If at any time during quarrying operations Buyer determines that rock, gravel and sand can no longer be profitably quarried and removed from the lands described in "Exhibit A" hereto, Buyer shall have the option to terminate this agreement upon sixty (60) days notice to Seller.
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> * * * * * * *
>
> 6. Buyer may erect upon the lands particularly described in "Exhibit A" hereto such machinery, trackage and roads as it may deem necessary or convenient for the proper and economical operation of the gravel pits and quarries upon said premises. All of such machinery and trackage shall at all times be the property of Buyer and it may remove the same at any time prior to the termination of this agreement or within a period of sixty (60) days thereafter. Any such machinery and trackage not so removed by Buyer

> within sixty (60) days after the termination of this agreement shall be deemed to be abandoned by Buyer and shall become the property of Seller.
>
> * * * * * * *
>
> 9. Buyer shall keep the lands described in "Exhibit A" free from any liens arising out of any work performed for, materials furnished to or obligations incurred by Buyer.
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> 10. Buyer shall, at its sole cost and expense, comply with all the requirements of all Municipal, State and Federal authorities now in force or which hereafter may be in force pertaining to its operations upon said premises, and shall faithfully observe in its operations on said premises all Municipal ordinances and State and federal statutes now in force or which may hereafter be in force. * * *
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> * * * * * * *
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> In the event that the base wholesale price for sand shall exceed $6.50 per ton, and in the event that the base wholesale price for rock or gravel shall exceed $6.40 per ton, then the purchase price to be paid by Buyer to Seller shall increase one cent (.01¢) per ton for each full twenty cents (.20¢) that the base wholesale price exceeds $6.50 per ton for sand and $6.40 per ton for rock and gravel.[3]

Rio Gravel's primary source of income during the years in issue was the proceeds received from Jamieson Co., pursuant to their agreement.

On July 11, 1972, Rio Gravel merged into petitioner, with petitioner being the surviving corporation. The agreement of merger provided (among other provisions):

> Upon such merger the separate corporate existence of Rio Gravel, Inc. shall cease and the surviving corporation shall become the owner, without other transfer, of all the rights and property of the constituted corporation, and the surviving corporation shall become subject to all debts and liabilities of the constituent corporations in the same manner as if the surviving corporation had itself incurred them.

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[3] Respondent introduced into evidence a contract dated Jan. 1, 1959, between Pleasanton Gravel Co. and Jamieson Co. for the removal of sand and gravel. Petitioner objected to this evidence on the grounds of relevancy. As we indicate in the text, *infra*, we feel that because the terms of the Pleasanton Gravel Co.-Jamieson Co. contract were substantially similar to the terms of the Rio Gravel-Jamieson Co. contract, the former is relevant to the extent it guides us in determining the nature of the payments therein. In the interests of judicial economy, we have not set forth the pertinent provisions of the Pleasanton Gravel Co.-Jamieson Co. contract because they appear in *Pleasanton Gravel Co. v. Commissioner*, 64 T.C. 510, 512–513 (1975), affd. per curiam 578 F.2d 827 (9th Cir. 1978), cert. denied 439 U.S. 1071 (1979).

The merger agreement did not specifically authorize the directors or officers of the surviving corporation to sign consents to extend the period of limitation on assessment of Federal tax deficiencies, nor did the agreement prohibit them from doing so.

The deficiencies in the present case relate to tax returns filed by Rio Gravel prior to the merger. For each of the taxable years ended July 31, 1968, July 31, 1969, July 31, 1970, July 31, 1971, and June 30, 1972 (final return), Rio Gravel timely filed a Federal Corporation Income Tax Return, Form 1120. On none of those returns did it indicate in the space provided that it was a personal holding company. Although the name and address of the shareholder were provided in an attachment to each of the returns, Rio Gravel did not provide any schedules enumerating the items of gross income and adjusted ordinary gross income. On each of the returns, Rio Gravel described the payments it received from Jamieson Co. as "royalties."

A Form 872A (Special Consent Fixing Period of Limitation Upon Assessment of Income Tax) was executed by the parties on July 16, 1974, and covered each of the taxable years in issue. The Form 872A named Pleasanton Gravel, Inc., Successor in Interest to Rio Gravel, Inc., as the taxpayer, was signed by G.W. Jamieson in his capacity as president of Pleasanton Gravel Co., and purportedly extended the period of limitation on assessment to December 31, 1976. Forms 872 (Consents Fixing Period of Limitation Upon Assessment of Income Tax) covering the same years mentioned above, were executed by the parties on September 16, 1974, October 1, 1976, September 19, 1978, and December 4, 1979, respectively. These also named Pleasanton Gravel Co., Successor in Interest to Rio Gravel, Inc., as the taxpayer, were signed by G. W. Jamieson in his capacity as president of Pleasanton Gravel Co., and purportedly extended the period of limitation on assessment to December 31, 1976, December 31, 1978, December 31, 1979, and June 30, 1981, respectively.

On June 4, 1981, respondent issued a statutory notice of deficiency to Pleasanton Gravel Co., Successor in Interest to Rio Gravel, Inc., determining that for each of the years in issue, Rio Gravel was a personal holding company, and as such, was subject to the personal holding company tax in the above-mentioned amounts.

OPINION

The first issue for decision is whether, for the taxable years ending July 31, 1968, through June 30, 1972, Rio Gravel was a personal holding company. If so, then the parties have stipulated it was subject to the 70-percent tax imposed by section 541 on its undistributed personal holding company income in the amounts determined by respondent to be the deficiencies for the years in issue.

As it read during the years in issue, section 542(a) defined a "personal holding company" to include any corporation satisfying the following requirements:

> (1) ADJUSTED ORDINARY GROSS INCOME REQUIREMENT.—At least 60 percent of its adjusted ordinary gross income (as defined in section 543(b)(2)) for the taxable year is personal holding company income (as defined in section 543(a)), and
>
> (2) STOCK OWNERSHIP REQUIREMENT.—At any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned directly or indirectly, by or for not more than 5 individuals. * * *

The parties have stipulated that Rio Gravel satisfied the stock ownership requirement during each of the relevant years. They disagree, however, as to whether Rio Gravel also met the first test relating to the composition of its "adjusted ordinary gross income."

It is not necessary for us to trace our way through the various complicated statutory provisions defining "adjusted ordinary gross income," for there is no dispute between the parties as to their application here at each step of the way. For our purposes, it is sufficient to state that in order to satisfy the adjusted ordinary gross income requirement, it is necessary to have the requisite amount of "personal holding company income" as defined in section 543(a). It is agreed by the parties that unless the payments received by Rio Gravel from Jamieson Co. were properly excluded from personal holding company income under section 543(a)(6), then the required amount of personal holding company income was present, and thus the adjusted ordinary gross income requirement of section 542(a)(1) was satisfied. We therefore proceed directly to the crucial issue of whether respondent correctly refused to exclude these payments from classification under section 543(a)(6).

As it read during the years in issue, the pertinent provisions of section 543(a) provided:

> SEC. 543(a). GENERAL RULE.—For purposes of this subtitle, the term "personal holding company income" means the portion of the adjusted ordinary gross income which consists of:
>
> * * * * * * *
>
> (6) USE OF CORPORATION PROPERTY BY SHAREHOLDER.—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled to the use of the property; whether such right is obtained directly from the corporation or by means of a sublease or other arrangement. This paragraph shall apply only to a corporation which has personal holding company income for the taxable year (computed without regard to this paragraph and paragraph (2), and computed by including as personal holding company income copyright royalties and the adjusted income from mineral, oil, and gas royalties) in excess of 10 percent of its ordinary gross income.

It is petitioner's primary contention that the second sentence of section 543(a)(6) means that if a corporation receives, *from other than its shareholders*, as little as 10 percent plus $1 of its ordinary gross income as mineral royalties, then all of the amounts received from its shareholders constitute personal holding company income. Here, however, except in 1972, Rio Gravel had no income, other than the payments received from its shareholder, Jamieson Co. Thus, because there was no income, other than from shareholders, the 10-percent test in the second sentence of section 543(a)(6) was not met, petitioner argues, and accordingly Rio Gravel did not have any personal holding company income. In so arguing, petitioner assumes, as it must, that the payments by Jamieson Co. to Rio Gravel, were otherwise classifiable under the first sentence of section 543(a)(6).

Respondent contends that the payments in issue should not be excluded under section 543(a)(6). He contends that the payments should have been classified under section 543(a)(3) as mineral royalties, and as such, the requisite amount of personal holding company income was present for purposes of section 542(a)(1).

The resolution of this controversy thus requires us to determine the breadth of the phrase "compensation (however designated and from whomsoever received) for the use of, or the right to use, property of the corporation" as it is employed in the first sentence of section 543(a)(6).[4]

In the interpretation and construction of statutes, it is our duty to ascertain and give effect to the intent of Congress from the language of the statute. If such language is susceptible of more than one meaning, resort may be had to the legislative history of the statute to determine the congressional intent. *Huntsberry v. Commissioner*, 83 T.C. 742, 747–748 (1984); *Abbott v. Commissioner*, 258 F.2d 537, 543 (3d Cir. 1958), affg. 28 T.C. 795 (1957); *Medical-Surgical Group, Inc. v. Commissioner*, 33 T.C. 888, 893 (1960).

We do not think that the language of section 543(a)(6), itself, clearly indicates what Congress intended to include within the scope of the phrase "compensation (however designated and from whomsoever received) for the use of, or the right to use property of the corporation." Respondent claims that the words as used in this context must be narrowly construed to mean "rent." Petitioner apparently argues that the words were intended to encompass all payments made by a shareholder to a corporation.

A review of the legislative history of section 543(a)(6) convinces us that Congress intended the phrase to apply only to "rents."

Provisions corresponding to section 543(a)(6) were first enacted in the Revenue Act of 1937. The purpose of this legislation was to close what had developed as a major defect in the personal holding company provisions, namely the failure to include certain *rent* as personal holding company income. This is made clear in the House report on this measure, wherein it was stated:

> Since under existing law, this type of compensation is not now included for the purpose of determining whether the corporation meets the 80 percent test, the taxpayer may fix such compensation in an amount sufficient to

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[4] For commentary on this subject see Morgan, "The Domestic Technology Base Company: The Dilemma of an Operating Company Which Might Be a Personal Holding Company," 33 Tax L. Rev. 233, 267–271 (1978).

> bring its other investment income below the 80-percent test. It has been shown to the committee that this device has been employed by taxpayers who had incorporated their yachts, city residences, or country houses and had paid sufficient *rent* to give the corporations enough income from their service to take them out of present section 351. By including this type of income in the definition of personal holding company income, your committee removes this method of tax avoidance. [H. Rept. 1546, 75th Cong., 1st Sess. 6 (1937), 1939–1 C.B. (Part 2) 707–708 (emphasis added). See also S. Rept. 1242, 75th Cong., 1st Sess. (1937), 1937–2 C.B. 609, 613; H. Doc. 337, 75th Cong., 1st Sess. 6 (1937).]

It is apparent that section 543(a)(6) was directed at the use of "rents" as a means of avoiding personal holding company status in order to build a tax shelter for other types of income within the definition of personal holding company income.

Problems developed when corporations renting property to their shareholders were caught within the web of the personal holding company tax, regardless of the bona fides of the transactions involved and the absence of an intent to avoid taxes. See, e.g., *Randolph Products Co. v. Manning*, 176 F.2d 190 (3d Cir. 1949). Thus, as part of the Revenue Act of 1950, section 543(a)(6) was amended to exempt from said section rents "received for the use by the lessee, in the operation of a bona fide commercial, industrial, or mining enterprise of property of the taxpayer." Again, the focus by the legislature was on "rents," which is supported by the following language contained in S. Rept. 2375, 81st Cong., 2d Sess. (1950), 1950–2 C.B. 557:

> section 502(f) [the predecessor to section 543(a)(6)] of the Code shall not apply with respect to *rents* received during the taxable years ending after December 31, 1945, and prior to January 1, 1950 if such *rents* were received for the use by the lessee in the operation of a bona fide commercial, industrial, or mining enterprise, of property of the taxpayer. [Emphasis added. See also S. Rept. 2375, *supra* at 530.]

In 1955, Congress, in Public Law 370, extended the application of section 543(a)(6) to cover the years 1950 to 1954. The House Ways and Means Committee reiterated that the 1950 amendment was "designed to take care of hardship cases which frequently arise where a corporation *rents* property to its principal stockholders." H. Rept. 1353, 84th Cong., 1st Sess. (1955), 1955–2 C.B. 845. (Emphasis added.)

From the above-quoted committee reports, it seems clear that in enacting section 543(a)(6) Congress was primarily concerned with payments by shareholders for the rental of corporate property. This interpretation is reinforced by the following language in the Senate Finance Committee report on the Internal Revenue Code of 1954:

> Subsection (a)(6), *relating to the inclusion in personal holding company income of rental income received from corporate shareholders*, is qualified to limit application of the paragraph to cases in which the corporation has other personal holding company income in excess of 10 percent of its gross income. * * * [S. Rept. 1622, 83d Cong., 2d Sess. 319 (1954) (emphasis added). See also S. Rept. 1622, *supra* at 74; H. Rept. 1337, 83d Cong., 2d Sess. 56 (1954).]

We find additional support for this proposition in *Montgomery Coca-Cola Bottling Co. v. United States*, 206 Ct. Cl. 864, 865 (1975),[5] where in a summary judgment proceeding the Court of Claims indicated:

> The legislative background of section 543(a)(6) and its predecessor sections show that the phrase "compensation * * * for the use of, or the right to use" as it is employed in the first sentence of section 543(a)(6) was only intended to apply to amounts received by the corporation as *rental* income. The first sentence of section 543(a)(6) does not include royalty income, and there is no indication that Congress intended royalties to be treated as rents in this instance. [Emphasis in original. Citations omitted.]

It is therefore apparent that "compensation (however designated and from whomsoever received) for the use of, or the right to use property of the corporation" refers exclusively to "rents." Thus, for petitioner to prevail on this issue, it must show that the payments in question constituted rent. If, however, as respondent contends, the payments constituted royalties, then we must decide this issue in favor of respondent.

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[5] Petitioner contends that *Montgomery Coca-Cola bottling Co. v. United States*, 206 Ct. Cl. 864 (1975), is not applicable to the facts here because three of the four courts (see also *Montgomery Coca-Cola Bottling Co. v. United States*, 615 F.2d 1318 (Ct. Cl. 1980); *Dothan Coca-Cola Bottling Co. v. United States*, 561 F. Supp. 1261 (M.D. Ala. 1982), affd. 745 F.2d 1400 (11th Cir. 1984)), reviewing the issue involved in that case agreed that royalties constituted rent within the meaning of sec. 543(a)(6). We do not agree with this statement. The only court which reached the narrow issue of whether royalties constituted rents for purposes of sec. 543(a)(6), indicated that they did not. *Montgomery Coca-Cola Bottling Co. v. United States*, 206 Ct. Cl. at 865. The remaining courts did not address this issue, but were concerned with whether the payments involved therein constituted rents or royalties and the standard of review to be applied.

The Code, the regulations, and the legislative history do not clearly delineate the difference between rents and royalties. See *Johnson Investment & Rental Co. v. Commissioner*, 70 T.C. 895, 900 (1978). We must therefore look to the courts which have passed on this issue for guidance.[6] In *Logan Coal & Timber Association v. Commissioner*, 122 F.2d 848, 850 (3d Cir. 1941), affg. 42 B.T.A. 529 (1940), the Third Circuit said that the difference between rents and royalties for purposes of the personal holding company provisions is:

> the commonly accepted one that rent is a compensation for the right to use property which is fixed and certain in amount and payable periodically over a fixed period regardless of the extent of the use of the property, while royalty is a compensation for the use of property which is based as to amount entirely upon the use actually made of the property. * * * [Fn. refs. omitted.]

The courts have adhered to this same basic distinction between rents and royalties on numerous occasions. *Johnson Investment & Rental Co. v. Commissioner, supra* at 901; *Warren Browne, Inc. v. Commissioner*, 14 T.C. 1056, 1063 (1950); *U.S. Universal Joints Co. v. Commissioner*, 46 B.T.A. 111, 115–116 (1942); *Kiesau Petroleum Corp. v. Commissioner*, 42 B.T.A. 69, 75–77 (1940); see also *Anderson v. Helvering*, 310 U.S. 404, 409 (1940); *Bayou Verret Land Co. v. Commissioner*, 450 F.2d 850, 853–855 (5th Cir. 1971), affg. on this issue 52 T.C. 971 (1969); *Campbell v. Great National Life Insurance Co.*, 219 F.2d 693, 695–696 (5th Cir. 1955).

When we apply the above standard to the payments from Jamieson Co. to Rio Gravel, there can be no doubt that such payments were royalties. Although the parties adopted the language of an outright sale in one portion of their agreement, this was merely a preliminary statement which was contradicted by other provisions therein. The heart of their arrangement was contained in the terms of paragraph 3, where they provided that Jamieson Co. was to pay Rio Gravel a specified amount for each ton of rock, sand, or gravel removed. This was the only consideration for the sand and gravel. The payments were not fixed and certain in amount, but rather, such payments were tied directly to the amount of rock, sand, or gravel that was quarried. As the quantity of rock extracted by Rio Gravel increased, so did the payments by Jamieson Co. It is also noteworthy that petitioner characterized the payments as royalties in the returns in issue.

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[6] We note in passing that in distinguishing between rents and royalties for purposes of the personal holding company provisions as well as other provisions of the Code, the courts have uniformly held that since the issue is one of interpreting a Federal statute, they are guided by the meaning intended by Congress rather than State law. *Johnson Investment & Rental Co. v. Commissioner*, 70 T.C 895, 901–902 (1978); *Webster Corp. v. Commissioner*, 25 T.C. 55, 60–61 (1955), affd. per curiam 240 F.2d 164 (2d Cir. 1957); *Western Transmission Corp. v. Commissioner*, 18 T.C. 818, 822–823 (1952).

It is true that Jamieson Co. acquired the right to possession of the land owned by Rio Gravel, but those possessory rights were merely incidental to the quarrying of the stone. See *Johnson Investment & Rental Co. v. Commissioner*, 70 T.C. at 902; *Logan Coal & Timber Association v. Commissioner*, 42 B.T.A. at 537. The critical distinction is that Jamieson Co. paid a fee which varied with the quantity of minerals removed.

We find additional support in *Pleasanton Gravel Co. v. Commissioner*, 64 T.C. 510 (1975), affd. per curiam 578 F.2d 827 (9th Cir. 1978), cert. denied 439 U.S. 1071 (1979), where we held that an almost identical agreement between petitioner and Jamieson Co. consituted a contract for royalty payments rather than a contract for the sale of its interest in the property involved.

For the above-stated reasons, we feel that the payments from Jamieson Co. to Rio Gravel constituted royalties rather than payments for rent, and thus were not properly classifiable under the first sentence of section 543(a)(6).[7]

Petitioner alternatively argues that even if the payments were not properly classifiable under section 543(a)(6), they were properly classifiable under section 543(a)(2), the provision for rents. As we have indicated *supra*, the payments constituted royalties, not rents, and as such, because the payments were for rock, sand, or gravel, they were properly classifiable under section 543(a)(3), the provision for mineral royalties. Petitioner, however, contends that section 543(b)(3), the definitional section for adjusted income from rents, requires us to reach a different result. Section 543(b)(3) provides:

> (3) ADJUSTED INCOME FROM RENTS.—The term "adjusted income from rents" means the gross income from rents, reduced by the amount subtracted under paragraph (2)(A) of this subsection. For purposes of the

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[7] Since we find that there has been a failure of compliance with the first sentence of sec. 543(a)(6), it is unnecessary to consider petitioner's contention in respect of alleged compliance with the second sentence of sec. 543(a)(6).

preceding sentence, the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but such term does not include—

(A) amounts constituting personal holding company income under subsection (a)(6),

(B) copyright royalties (as defined in subsection (a)(4)),

(C) produced film rents (as defined in subsection (a)(5)(B)), or

(D) compensation, however designated, for the use of, or the right to use, any tangible personal property manufactured or produced by the taxpayer, if during the taxable year the taxpayer is engaged in substantial manufacturing or production of tangible personal property of the same type.

Petitioner submits that because section 543(b)(3) does not contain a specific exclusion for mineral royalties (as it does, for example, for copyright royalties) that Congress intended to include mineral royalties within the definition of rents in section 543(b)(3). We disagree. Congress specifically provided a definitional provision for adjusted income from mineral royalties in section 543(b)(4). If we were to interpret section 543(b)(3) so as to include mineral royalties within the definition of rent, then section 543(b)(4) would be unnecessary, a result Congress clearly did not intend. It is a well-accepted rule of statutory construction that the various sections of the Code should be construed so that one section will explain and support and not defeat or destroy another section. *Crane v. Commissioner*, 331 U.S. 1, 13 (1947); *Bernier v. Bernier*, 147 U.S. 242, 246 (1893); *Brons Hotels, Inc. v. Commissioner*, 34 B.T.A. 376, 381 (1936).

In sum, we hold that payments in issue were mineral royalties, and thus properly classifiable under section 543(a)(3). The parties are in agreement that if the payments are classified under section 543(a)(3) then the requisite amount of personal holding company income was present. Respondent properly characterized Rio Gravel as a personal holding company.

The second issue for decision is whether respondent is barred from the assessment and collection of the deficiencies herein, due to the expiration of the applicable period of limitation, as pleaded by petitioner.

Section 6501(f) provides that if a corporation which is a personal holding company fails to file with its return a schedule setting forth the items of gross income and adjusted ordinary gross income, and the names and addresses of its stockholders owning more than 50 percent of the outstanding stock, then respondent has 6 years after the taxpayer's return is filed within which to commence statutory proceedings for assessment and collection of tax by the mailing of a deficiency notice. We have already determined that Rio Grande is a personal holding company; therefore, because Rio Grande failed to attach a schedule enumerating the items of gross income and adjusted ordinary gross income, the 6-year statute is applicable.[8]

Rio Gravel's income tax returns for the fiscal years ending July 31, 1968, through June 30, 1972, were timely filed with respondent; consequently, the 6-year statute of limitations under section 6501(f) for these years would have expired, respectively, on October 15, 1974, October 15, 1975, October 15, 1976, October 15, 1977, and September 15, 1978.

Section 6501(c)(4) allows the prescribed statute of limitations to be extended by agreement between the parties, so long as such consent is executed while the statute of limitations is still open. In the absence of valid consents, however, the period of limitation on assessment and collection against Rio Gravel would have expired on September 15, 1978. The notice of deficiency mailed on June 4, 1981, would thus be untimely.

Here, numerous consecutive consents were executed for the returns in issue, extending the period of assessment and collection for those years, until, ultimately, June 30, 1981. As shown in our findings, each was executed while the statute of limitations was still open. Accordingly, the resolution of the issue involved herein turns on whether the consents extending the statute of limitations were validly executed.

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[8] Petitioner apparently contends that sec. 6501(f) is inapplicable because all of the information sought therein was contained in Rio Gravel's returns, albeit not on a separate schedule. This argument was previously dealt with in *Pleasanton Gravel Co. v. Commissioner*, 64 T.C. 510, 527 (1975), affd. 578 F.2d 827 (9th Cir. 1978), cert. denied 439 U.S. 1071 (1979), where we indicated to the same petitioner as is involved in the instant case, that it is insufficient to receive the information in some form, but rather, it must be provided in a uniform manner so that the physical task of handling and verifying returns may be readily accomplished.

Petitioner argues that *Pleasanton Gravel* is distinguishable because if, as was the case here, the personal holding company box on Form 1120 is not checked, then no special procedures to test for personal holding company income are performed by respondent, and therefore it is unnecessary to attach a separate schedule. We do not believe that this argument provides any basis for distinguishing *Pleasanton Gravel*. To the contrary, the reason no special procedures are performed by respondent in such a situation is because the taxpayer has effectively disguised, or at least failed to reveal, the fact that it is a personal holding company.

Petitioner initially contends that no one had the authority to act on behalf of Rio Gravel in executing the waivers, since Rio Gravel had ceased to exist after it merged into petitioner. Respondent, on the other hand, contends that the consents were validly executed by petitioner as successor in interest to Rio Gravel.

The parties are in agreement that the validity of the consents (at least with respect to petitioner's *capacity* to execute) is to be determined under the laws of the State of California, where they were executed. See *Lesser v. Commissioner*, 47 T.C. 564, 591 (1967); see also *United States v. Krueger*, 121 F.2d 842 (3d Cir. 1941); *Sanderling, Inc. v. Commissioner*, 66 T.C. 743, 750 (1976), affd. on this issue 571 F.2d 174 (3d Cir. 1978).

The provisions of the California Corporation Code (West 1977) pertinent to this case are set forth in the footnote below.[9] Under these provisions, the separate existence of Rio Gravel ceased when all of the requisite formalities of the merger had been completed, at which time petitioner, as the surviving corporation, took all of the *rights* and assumed all of the *obligations* of Rio Gravel as its own. The agreement of merger herein contained similar language.

It has been held that taxes are debts or liabilities. See *United States v. Scott*, 167 F.2d 301 (8th Cir. 1948). It follows that petitioner, who became primarily liable for the tax liabilities of Rio Gravel after the merger under California law, had the power under State law to extend the period of limitation for its own direct liability, just as its predecessor, Rio Gravel, would have had. See and compare *Union Bleachery v. Commissioner*, 97 F. 2d 226, 228 (4th Cir. 1938), affg. a Memorandum Opinion of this Court; *Phillips v. Lyman H. Howe Films Co.*, 33 F.2d 891 (3d Cir. 1929); *Popular Library, Inc. v. Commissioner*, 39 T.C. 1092 (1963).

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[9] Sec. 1107 Effect of merger; rights of creditors; liens; pending actions or proceedings

(a) Upon merger pursuant to this chapter the separate existence of the disappearing corporations ceases and the surviving corporation shall succeed, without other transfer, to all the rights and property of each of the disappearing corporations and shall be subject to all the debts and liabilities of each in the same manner as if the surviving corporation had itself incurred them.

Petitioner argues that the Form 872 purporting to extend the statute of limitations to December 31, 1978, was not valid because the corporation's name did not appear next to the signature of G.W. Jamieson. The last paragraph of the instructions on the Form 872 in issue instructs "If the taxpayer is a corporation, this consent must be signed with the corporate name followed by the signature and title of the officer(s) authorized to sign." Here, the form was addressed to "Pleasanton Gravel Co., Successor in Interest to Rio Gravel, Inc." and was signed "G.W. Jamieson Pres," thus it was unnecessary for the corporate name to appear again beside Mr. Jamieson's signature. Moreover, the other four consents all listed the corporation's name next to his signature. We therefore agree with respondent that this mere clerical error does not invalidate an otherwise proper waiver. See *Lefebvre v. Commissioner*, T.C. Memo. 1984-202, affd. per curiam 758 F. 2d 1340 (9th Cir. 1985); *Illinois Addressograph Manufacturing Co. v. Commissioner*, 31 B.T.A. 498 (1934); *Rauh v. Commissioner*, 22 B.T.A. 662 (1931). See also *William S. Dorg, Inc. v. Commissioner*, 13 B.T.A. 256 (1928) (waiver signed by corporate officer was binding despite absence of corporate seal).

It is urged by petitioner that pursuant to *Lesser v. Commissioner*, 47 T.C. at 591, the burden of proof is on respondent to show that G.W. Jamieson was authorized to sign the consent. We agree that when respondent relies on the exception to the running of the period of limitation provided by section 6501(c)(4), he bears the burden of showing the necessary waivers. However, waivers valid on their face and introduced into evidence by respondent shift the burden of going forward with the evidence back to petitioner, upon whom the burden of proof on the statute of limitations issue lies, to show invalid execution. *Concrete Engineering Co. v. Commissioner*, 19 B.T.A 212 (1930), affd. 58 F.2d 566 (8th Cir. 1932); *Stern Bros. & Co. v. Burnet*, 51 F.2d 1042 (8th Cir. 1931), affg. 17 B.T.A. 848 (1929); *Adler v. Commissioner*, 85 T.C. 535 (1985); *Lefebvre v. Commissioner, supra*.[10]

Here the consents appear to be regular on their face, in accordance with the law, and signed by Mr. Jamieson as president of petitioner. Petitioner has not offered any evidence as to lack of his authority, and has accordingly failed to carry its burden on the question of proper execution. See *National Water Main Cleaning Co. v. Commissioner*, 16 B.T.A. 223 (1929).

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[10] See also *Fiore v. Commissioner*, T.C. Memo. 1979-360, affd. without published opinion 636 F.2d 1208 (3d Cir. 1980).

Petitioner alternatively argues that the consents were invalid because they were not intended to apply to deficiencies in the personal holding company tax. Petitioner apparently contends that each waiver is for the assessment of income taxes, and therefore should not have been used here because the personal holding company tax is not an income tax, but rather, a penalty tax imposed on corporations for shielding passive income. With this we cannot agree. The personal holding company tax is imposed by section 542, which is located in subtitle A entitled "Income Taxes." Penalties and additions to tax, however, are found in subtitle F entitled "Procedure and Administration." Nonetheless, even if petitioner's contention is correct, in *Picard v. Commissioner*, 28 T.C. 955, 961 (1957), we indicated that the word "tax" in such waivers included any applicable interest, penalty, or other additions to tax. See also *Marbut v. Commissioner*, 28 T.C. 687 (1957). We think that the waivers in the instant matter embraced the personal holding company tax. See *Commercial Finance Co. v. Commissioner*, T.C. Memo. 1968-229.

We accordingly hold that respondent is not time-barred from assessing and collecting the personal holding company tax owed by petitioner.

Decision will be entered for the respondent.

COLONIAL SAVINGS ASSOCIATION AND SUBSIDIARIES, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 25477-82. Filed November 26, 1985.

P, a savings and loan association, was entitled to receive penalties from depositors because of premature withdrawals from their accounts. P generally credited depositors' accounts with compound interest on a daily basis. Depositors were entitled to withdraw the interest, but incurred a penalty if principal was withdrawn before maturity of the certificate. P contends that the penalties are income from discharge of indebtedness within the meaning of sec. 108, I.R.C. 1954, and may be deferred in accord with Sec. 1017, I.R.C. 1954. Respondent agrees that the penalties are income to P, but contends that the penalties, which are reduced from the remaining principal and interest in the depositors' accounts, do not give rise to income from discharge of indebtedness. *Held*, the penalty for premature withdrawal does not give rise to income from discharge of indebtedness within the meaning of secs. 108 and 1017, I.R.C. 1954.

Robert A. Schnur, for the petitioners.
Mark D. Petersen, for the respondent.

GERBER, *Judge*: Respondent determined a deficiency of $5,000 in petitioners' taxable year ended June 30, 1980. Due to an agreement of the parties,[1] the sole issue for our consideration is whether income received by financial institutions as penalties for premature withdrawal is to be treated as income from discharge of indebtedness within the meaning of section 108.[2] This is an issue of first impression.

FINDINGS OF FACT

All of the facts have been stipulated and are found accordingly. The stipulation of facts and attached exhibits are incorporated by this reference. The factual pattern in this case is essentially the same as that presented in Rev. Rul. 83–60, 1983–1 C.B. 39, and respondent contends that the rationale of that ruling is dispositive of the issue before us.[3] We are, of

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[1] Respondent determined several adjustments to the amounts reported by petitioners. For purposes of this opinion, however, the only issue for our consideration deals with cancellation of indebtedness. With respect to another pending issue, the parties in this case have agreed to be bound by the final decision in *Frontier Savings & Loan Association v. Commissioner*, docket No. 24559–83 (including any appeal thereof). Because of concessions by petitioners, a Rule 155 computation, Tax Court Rules of Practice and Procedure, will be necessary if respondent does not prevail in either of the remaining issues.

[2] All statutory references are to the Internal Revenue Code of 1954 as amended and in effect for the taxable year at issue.

[3] In pertinent part, the facts of Rev. Rul. 83–60, 1983–1 C.B. 39, are as follows:

FACTS

The taxpayer is a financial institution that issues savings certificates with terms of maturity varying from 6 months to 10 years. Federal regulations pertaining to these certificates require a holder to forfeit an amount as a penalty for withdrawal of the funds before the stated term of maturity. The amount of this premature withdrawal penalty is prescribed by the Depository Institutions Deregulation Committee (DIDC), which was established by the Depository Institutions course, aware that a revenue ruling merely represents the position of one of the litigants in this case, the Commissioner of Internal Revenue.

Colonial Savings Association (petitioner), a Wisconsin savings and loan associations organized on August 26, 1892, was owned by approximately 17,000 depositors as of June 30, 1980. Petitioner has two wholly owned subsidiaries: Brown County Service Corp., incorporated in 1975, and Colonial Financial Services, Inc., incorporated in 1976. References to petitioner in the singular will be to Colonial Savings Association. Petitioner's principal corporate office is in Green Bay, Wisconsin. Branch savings and loan offices are also maintained at several locations in Green Bay and Appleton, Wisconsin.

Petitioner, a cash basis taxpayer, timely filed a consolidated corporate income tax return (Form 1120) with the Internal Revenue Service Center, Kansas City, Missouri, for its taxable year ended June 30, 1980.

When a depositor opened an account, petitioner provided the depositor with a certificate describing the account. If the depositor renewed the account, a new certificate was not issued, but petitioner sent a notice informing the depositor of any changes in the terms of the account. The parties have agreed that the certificates and notices of changes included terms that complied with all laws and regulations applicable to savings accounts at the time of issuance.

Petitioner's accounts included certificates with terms ranging from 3 months to 8 years.[4] Interest was compounded on

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Deregulation Act of 1980, section 203, 12 U.S.C. section 3502 (1980). * * *

* * * * * * *

The regulation provides a premature withdrawal penalty that may cause, in effect, a forfeiture of principal, as well as interest. If the deposited funds are withdrawn before the specified amount of interest is earned, or before it could have been earned, then a portion of the principal must be forfeited to pay the prescribed penalty.

Under the taxpayer's contracts with its savings certificate holders, interest at a fixed rate is paid or credited to accounts of the holder either monthly or quarterly at the holder's option. The interest is withdrawable on demand and without penalty. The taxpayer's contracts also contain the terms of the penalties required by the above DIDC regulation for premature withdrawal. Should a holder incur a premature withdrawal penalty after withdrawing interest earned, a corresponding reduction is made in principal returned to the holder.

The taxpayer reported on its federal income tax return its income attributable to premature withdrawal penalties as income from the discharge of indebtedness under section 108 of the Code. Thus, the taxpayer excluded the amount of the penalties from its gross income and elected to reduce under section 1017 the basis of its depreciable property by the amount excluded.

[4] Petitioner had the following types of accounts based on their maturities: 3-month, 6-month, 1-year, 2-year, 2½-year, 3-year, 4-year, 6-year, and 8-year certificates.

these accounts on a daily basis with petitioner adding, on its computer records, the daily interest each day to the depositor's account.[5] With respect to petitioner's 6-month certificates, petitioner computed and added the interest to a depositor's account on a daily basis in the same manner as the other accounts, except that the interest was not compounded.

Some of the depositors' accounts were opened during petitioner's taxable year ended June 30, 1980. The remainder of the accounts were opened in prior years, and either the initial term had extended into or through petitioner's 1980 taxable year, or the initial term had expired on prior years, but the depositor had renewed the account at least once for a term extending into or through petitioner's 1980 taxable year. Petitioner's total deposits were $106,383,872 at the beginning of its 1980 taxable year, and $123,617,503 on June 30, 1980, at the end of its taxable year.

On any given day, a depositor could withdraw the principal balance in his account, plus the interest shown on petitioner's computer records as earned through such date, less any accrued interest that the depositor had already withdrawn. If a depositor requested the withdrawal of the principal in any account prior to maturity, the depositor was required, both pursuant to the terms of the certificates and Federal regulation,[6] to forfeit an amount as a penalty for withdrawal of the funds before the certificates reached maturity.[7] When a penalty for premature withdrawal was incurred, the depositor received a netted amount, composed of the principal on deposit plus interest payable to the date of withdrawal, less the penalty for premature withdrawal. The mandatory forfeitures were therefore "paid" by reducing the amounts payable to the depositor by the amount that the depositor had agree to pay and was required to forfeit. In no event did a depositor "pay" the forfeiture after first receiving the full amount due on a certificate.

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[5] The amount of daily interest was computed by applying the applicable annual interest rate to the amount on deposit (including previously compounded interest) and then dividing the result by 360.

[6] The amount of the premature withdrawal penalty has been prescribed by the Depository Institutions Deregulation Committee (DIDC) since July 31, 1980. Prior to that time, the Federal Home Loan Bank promulgated the regulations. For accounts opened or renewed after June 30, 1979, and before June 2, 1980, the regulations required the depositor to forfeit 3 months' interest on accounts with terms of 1 year or less and required the depositor to forfeit 6 months' interest for accounts with terms exceeding 1 year. If the account was open for less than the 3-month or 6-month minimum penalty period, whichever was applicable, the depositor was required to forfeit all the interest. 12 C.F.R. sec. 526.7(a) (1979).

For accounts opened or renewed after June 1, 1980, the depositor was required to forfeit all the interest which could have been earned, whether earned or not, for accounts with terms of less than 3 months. For accounts with terms from 3 months to 1 year, the depositor was required to forfeit 3 months' interest, whether earned or not. And for accounts with terms of more than 1 year, the depositor was required to forfeit 6 months' interest, whether earned or not. 12 C.F.R. sec. 1204.103 (1981).

[7] The penalty for premature withdrawal may cause a forfeiture of principal as well as interest. Classification of whether interest or principal is being forfeited does not change the outcome of this case.

Petitioner's books, for the period beginning July 1 to September 4, 1979, reflected the deduction of a net amount under section 591, comprised of gross interest accrued, less the amount of premature withdrawal forfeitures. Thus, petitioner treated the forfeitures during that period (in the amount of $8,024.04) as a reduction of its total interest deduction for that period. For the period beginning September 4, 1979, petitioner deducted the total amount of each day's interest as and when such interest was shown on petitioner's computer records. Petitioner treated the premature withdrawal forfeitures during this period as income from the discharge of indebtedness under section 61(a)(12) and excluded that amount from its gross income under section 108. Petitioner timely elected to treat the amount so excluded as a reduction in petitioner's basis of property under section 1017.

The total amount petitioner deducted during the taxable year ended June 30, 1980, after the offsets for early withdrawal forfeitures described above, was $10,372,635.95. The total amount forfeited by depositors due to early withdrawals from accounts on deposit was $600,744.88.

Petitioner contends that its method of handling the forfeitures prior to September 4, 1979, was incorrect. Petitioner believes that such method was incorrect because the forfeitures should always have been treated as income from the discharge of indebtedness.[8]

OPINION

It is well settled that gross income means gross income from whatever source derived. Sec. 61(a). Gross income includes income from discharge of indebtedness. Sec. 61(a)(12). A taxpayer may realize income by paying an obligation at less than its face value. *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3 (1931), revg. 71 Ct. Cl. 290, 44 F.2d 885 (1930); sec. 1.61-12(a), Income Tax Regs. For transactions occurring on or before December 31, 1980, however, no amount is included in gross income by reason of the discharge of any indebtedness for which a corporate taxpayer is liable if the taxpayer files a consent to the regulations prescribed under section 1017 relating to the adjustment of basis of property. Sec. 108.[9]

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[8] Petitioner does concede, however, that it made certain errors in calculating the amount to be excluded and that, if the early withdrawal forfeitures do constitute income from discharge of indebtedness, the amount that should be excluded under sec. 108 is $591,896.36.

This is the first instance where a court has been asked to determine whether the receipt of premature withdrawal penalties is income from discharge of indebtedness within the meaning of sections 108 and 1017. Petitioner asserts that, but for section 108(a), these forfeited amounts would be includable in petitioner's gross income under section 61(a)(12). Respondent, on the other hand, asserts that not every indebtedness that is canceled results in gross income being realized "by reason of" cancellation of indebtedness. Rather, respondent argues that section 108 does not apply if the cancellation is simply the "medium" for payment. Respondent reasons that the penalty is a form of agreed upon or liquidated damages which the depositor has agreed to pay for the right to withdraw the funds at any time and to compensate the financial institution for lost profits, and thus the amount the depositor forfeits is simply the "medium" to pay this debt.

In addition, respondent argues that, pursuant to the contractual agreement between petitioner and depositors, petitioner was to be compensated if the funds were demanded early. The value of giving up the right to use the funds until maturity presumably equals the amount of the penalty and there was no cancellation of indebtedness because the financial institution received value equal in amount to the withdrawal penalty thus satisfying the debt in full. Petitioner counters that there was no payment and therefore there should not be any two-step analysis as respondent asserts. The statutes (sections 61(a)(12) and 108) are stark and undetailed. They cryptically provide that income from discharge of indebtedness is includable in gross income unless the taxpayer files a consent to defer the income pursuant to section 1017. These statutes, until 1980 revisions, have existed for over four decades without a definition of indebtedness or its cancellation. The gist of this case is whether the indebtedness (principal or interest) owed to the depositor has been "canceled" by means of the parties' agreement to reduce the indebtedness by the amount of a penalty for premature withdrawal of the indebtedness. More specifically, is this penalty a forgiveness, discharge, or cancellation within the meaning of sections 61(a)(12) and 108 and underlying case precedents? We hold that the forfeiture in this case is not a discharge of indebtedness within the meaning of the statutes and *United States v. Kirby Lumber Co., supra*, and its progeny. As more fully discussed in the foregoing opinion, we find that the forfeiture was a separate and distinct obligation required of depositors for early withdrawal and not a forgiveness or discharge of the debt. The debt to the depositor was not canceled or discharged, it was simply reduced.

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[9] The Bankruptcy Tax Act of 1980, Pub. L. 96-589, sec. 2(a), 94 Stat. 3389, amended sec. 108. For transactions occurring after Dec. 31, 1980, sec. 108(a) and (d)(4) provides that gross income does not include any amount which would be includable in gross income by reason of the discharge of indebtedness of the taxpayer if the indebtedness discharged is indebtedness incurred or assumed by a corporation or an individual in his trade or business that makes an election under sec. 108(d)(4) with respect to the indebtedness.

Sec. 108 normally results only in postponement, rather than forgiveness, of taxable income by reducing the basis of depreciable assets under sec. 1017 and thereby assuring that the excluded income would reduce deductions from ordinary income in future years. Because the 1980 amendment applies in general only to transactions occurring after Dec. 31, 1980, the 1980 amendment does not apply to this case.

Prior to 1931, the Government was singularly unsuccessful in promoting the concept that income could be realized due to the discharge of indebtedness.[10] *Meyer Jewelry Co. v. Commissioner*, 3 B.T.A. 1319 (1926); *American Tobacco Co. v. Commissioner*, 20 B.T.A. 586, 588 (1930) (and cases cited therein). These cases focused upon the constitutional definition of income and the holdings of *Eisner v. Macomber*, 252 U.S. 189 (1920), and *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926).

In 1931, however, the Government's position that income could be realized due to discharge of indebtedness met with success in *United States v. Kirby Lumber Co., supra*. The *Kirby* holding essentially rationalized that a reduction in debt (liabilities) without a corresponding reduction of assets causes income by unencumbering the assets and providing an economic gain or realizable event.[11]

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[10] In attempting to develop a historical perspective of this area of the tax law, we were confronted by a confusing line of precedent. A noted commentator has also called it "One of the murkiest pools of obscurity in the tax law * * *" and suggested that "logic has taken an extended vacation in the debt cancellation area." Eustice, "Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion," 14 Tax L. Rev. 225, 286 (1959). Interestingly, that comment, although more than a quarter of a century old, is still true.

The Government has managed to protect its *Kirby* win over the past 55 years with certain exceptions.[12] In situations where the cancellation of a debt was a gift or gratuitous act, courts have held that income from discharge of indebtedness did not occur. *Helvering v. American Dental Co.*, 318 U.S. 322 (1943); *Edmont Hotel Co. v. Commissioner*, 10 T.C. 260 (1948). But see *Commissioner v. Jacobson)*, 336 U.S. 28 (1948). In a similar vein, courts have held that debt forgiveness by a shareholder-creditor is a contribution to capital, rather than income to the corporation due to the forgiveness of indebtedness. *Commissioner v. Fender Sales, Inc.*, 338 F.2d 924, 930 (9th Cir. 1964), cert. denied 382 U.S. 813 (1965). In *Putoma Corp. v. Commissioner*, 66 T.C. 652, 663–672 (1976), affd. 601 F.2d 734 (5th Cir. 1979), we analyzed the precedential relationship between the tax benefit rule, the *Kirby* holding, and the contributions to capital exception.

Another line of cases provides an exception to *Kirby* where there is essentially no indebtedness or the debt is contingent. An example of this exception involves a situation where a taxpayer satisfied an outstanding real property lien with municipal bonds purchased at a discount. *Hotel Astoria, Inc. v. Commissioner*, 42 B.T.A. 759 (1940). Because the Hotel Astoria was not "personally" responsible for the lien which attached to acquired real property, the Board reasoned that the hotel's use of discounted bonds "simply represented an additional investment * * * in the hotel property." (42 B.T.A. at 764.) Another example may be found in *N. Sobel, Inc. v. Commissioner*, 40

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[11] *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), which was founded on the major premise that debt cancellation did not, in the constitutional sense, generate income was overruled or modified by *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), revg. 71 Ct. Cl. 290, 44 F.2d 885 (1930). With respect to borrowing and repayment in the same foreign currency, the vitality of its holding is said to have been lost. *National-Standard Co. v. Commissioner*, 80 T.C. 551, 568 (1983) (Tannenwald, *J.*, dissenting), affd. 749 F.2d 369 (6th Cir. 1984). To the extent that the overall effect of the transaction produces a loss to the debtor, *Kerbaugh-Empire* retains some vitality. *See Vukasovich, Inc. v. Commissioner*, T.C. Memo. 1984-611, on appeal (9th Cir., Apr. 30, 1985).

[12] A relatively recent law review article provides a categorization and analysis of the exceptions to the *Kirby* holding. Powell, "A Review of Judicial Exceptions to the Kirby Rule," 30 Fla. L. Rev. 94 (1977).

B.T.A. 1263 (1939), where the Board found the taxpayer's "liability" to be so indefinite and unfixed that it could not be canceled or otherwise reduced. (40 B.T.A. at 1265.) These exceptions tell us that there must be a liquidated debt and it must be the taxpayer's personal obligation in order for *Kirby* to apply.

Another exception to *Kirby* is where the evidence of indebtedness is merely reissued or modified and the underlying debt remains. *Tower Building Corp. v. Commissioner*, 6 T.C. 125 (1946). Here the debt had not been canceled, merely the evidence of it changed. The result might have been different if the par value of the new instrument or evidence of indebtedness was greater or less than that of the old.

Where the value of the asset falls below the balance of the debt it secures and the parties agree upon a reduction in the debt, another exception to *Kirby* has been carved. This exception seems to align with the *Kirby* rationale in that the reduction of the debt would release assets for the debtor's use. *Gehring Publishing Co. v. Commissioner*, 1 T.C. 345 (1942). Likewise, where the asset is voluntarily or involuntarily transferred to the holder of the secured indebtedness, the transaction is treated as a sale or exchange. *Electro-Chemical Engraving Co. v. Commissioner*, 311 U.S. 513 (1941); *Millar v. Commissioner*, 67 T.C. 656, 660 (1977), affd. 577 F.2d 212 (3d Cir. 1978).

It is helpful to understand the legislative background that preceded congressional enactment of sections 108 and 1017. Initially, following the Supreme Court's 1931 opinion in *Kirby*, relief was provided for bankrupt debtors in the form of a basis reduction. Bankruptcy Act of 1898, as amended by the Act of June 22, 1938 (Pub. L. 696, 52 Stat. 840), secs. 268 and 270. This type of relief was extended to insolvent debtors ("in an unsound financial condition") by section 215(a) of the Revenue Act of 1939. Secs. 22(b)(9), 113(b)(3), I.R.C. 1939. In 1942, the "unsound financial conditions" requirement was removed from section 22(b)(9), I.R.C. 1939, because it denied benefits to many meritorious cases.[13] The provisions of sections 22(b)(9) and 113(b)(3), I.R.C. 1939, were reenacted into sections 108 and 1017 without significant change. It appears that the intended relief was to provide deferral of the recognition of realized income which has been "trapped" in assets and which may not be liquid. Initially, such relief was provided for bankrupts and insolvent entities where the recognition would cause acute hardship. In extending this relief to any taxpayer-debtor with income from discharge of indebtedness, Congress did not express an intent to expand the circumstances under which a discharge of indebtedness might occur. *Estate of Delman v. Commissioner*, 73 T.C. 15, 31–40 (1979).

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[13] S. Rept. 1631, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 504.

Petitioner contends that the forfeiture, in the form of an "early withdrawal penalty," results in "income by reason of the discharge of indebtedness" under section 108.[14] Petitioner argues that it satisfied a portion of its indebtedness by paying less to its creditor-depositors than the face amount of their debt. Because many of the depositors made the early withdrawal to take advantage of improved interest rates, petitioner sees a parallel to the original congressional purpose to provide relief from "changed economic conditions."[15]

Respondent's position, as set forth in Rev. Rul. 83–60, 1983–1 C.B. 39, and on brief is essentially that the depositors' early withdrawal triggering forfeiture is the "medium" for payment of a penalty which is used to reduce the amount of interest payable to the depositors. Stated another way, the penalty or forfeiture constitutes part of the payment of the interest credited to the depositors' accounts and deducted by petitioner. Respondent's "medium" for payment position has also been referred to as a "spurious" cancellation of indebtedness.[16] "Spurious" cancellation, as defined by its authors, exists when

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[14] The parties have agreed (1) that petitioner has realized income, (2) that both the principal and interest reflected in depositors' accounts were "legally binding indebtedness," and (3) that petitioner has made a proper election. The sole dispute is whether the penalty or "forfeiture" constitutes discharge (cancellation or forgiveness) of indebtedness.

[15] Petitioner's attempt to bring the facts of this case within the original purposes and requirements for the predecessor of sec. 108 is inapposite. In this instance the creditor, not the debtor, is ostensibly attempting to improve his financial condition (investing his money at higher interest rates) rather then being subjected to unfavorable conditions, i.e., insolvency or reduction in value of assets. Moreover, petitioner does not appear to have an unsound financial condition or other unfavorable conditions. Petitioner had the use of depositors' funds and, by agreement (which was also pursuant to regulation), paid a net amount of interest which was less than originally agreed or no interest at all in some situations. Further, petitioner is permitted under sec. 591 to deduct the entire amount that had been credited to depositors' accounts without being required to make actual payment. At that juncture, petitioner seeks to defer the admitted resultant income by reporting the income as from discharge of indebtedness.

[16] See Bittker & Thompson, "Income From the Discharge of Indebtedness: The Progeny of *United States v. Kirby Lumber Co.*," 66 Cal. L. Rev. 1159, 1174–1175 (1978).

"careful analysis discloses that the debt was not discharged for less than its face amount but was in fact fully paid." Bittker & Thompson, "Income From the Discharge of Indebtedness: The Progeny of *United States v. Kirby Lumber Co.*," 66 Cal. L. Rev. 1159, 1174 (1978). The above-cited authors employ the following example of a "spurious" cancellation of indebtedness:

> if an employer lends $50 to an employee with the understanding that the debt will be deducted from the employee's next paycheck, the debt is paid in full on payday even though no cash changes hands and the transaction is formally termed a "cancellation." The employee must report $50 as income, not because the debt has been cancelled for less than its face amount within the meaning of *Kirby Lumber*, but because he has been paid in full for his services. [Bittker & Thompson, *supra* at 1174.]

Petitioner contends that it had "pure" and not "spurious" cancellation of indebtedness because no consideration passed from petitioner to the depositors for the discharge (forfeiture) as it had from the employee to the employer in the above-cited example. The parties[17] have focused their attention on whether there was one or two transactions between petitioner and each depositor. Ostensibly, the parties must believe that it is necessary to have two separate transactions or events to fall within the "spurious" cancellation area, i.e., indebtedness and separate consideration for its reduction, rather than discharge. Petitioner argues that its relationship with the depositors was solely that of debtor and creditor and the "forfeiture" constituted a discharge of the sole object of the relationship—the debt. Respondent, on the other hand, has ruled[18] that the depositor's liability for the penalty is contractual and also required by DIDC[19] regulations. Respondent's contention is that the forfeiture is "in the nature of agreed-upon fees or liquidated damages intended both as consideration for the early withdrawal privilege, and as compensation to the taxpayer for loss of the use of the deposited funds for the full term of the certificate."

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[17] By an order dated Nov. 8, 1984, the United States League of Savings Institutions was granted leave to file briefs as amicus curiae. Its briefs have been considered regarding this and other aspects of this case. The briefs of the "League" solely support petitioner's position.

[18] Rev. Rul. 83-60, 1983-1 C.B. 40-41.

[19] DIDC (Depository Institutions Deregulation Committee) was established by the Depository Institutions Deregulation Act of 1980, sec. 203, 12 U.S.C. sec. 3502 (1980).

We agree with both parties that the net effect of or the "forfeiture" itself causes the realization of income to petitioner. We disagree with petitioner, however, that this income is from the discharge of indebtedness. Section 108 only applies to "pure" cancellation of indebtedness income; it does not apply if the debt forgiveness is simply the method by which a creditor makes a payment to a debtor. *OKC Corp. & Subsidiaries v. Commissioner*, 82 T.C. 638, 649 (1984); *Spartan Petroleum Co. v. United States*, 437 F. Supp. 733, 737 (D. S.C. 1977); Bittker & Thompson, *supra* at 1186.

In this case petitioner and each depositor agreed, in substance, as follows: Petitioner agreed to pay interest at a fixed rate and on certain dates if the depositor agreed to deposit an amount of money for a fixed period. The depositor agreed to be subject to a penalty[20] if withdrawals, below a minimum balance requirement, occurred at certain times prior to maturity of the certificate or account. Petitioner, pursuant to section 591, deducted the entire amount of interest accrued in each depositor's account, without reduction for the penalties or forfeitures.[21] This factual pattern does not give rise to cancellation or discharge of the debt. The debt (interest) was credited to the depositor's account and (subsequent to September 4, 1979) deducted in full by petitioner.[22] The depositor was subject to a penalty, depending upon the extent of prematurity of withdrawal, which would either reduce or completely eliminate the interest credited. Further, the depositor may have the principal subjected to the penalty depending upon the prematurity of withdrawal and/or the amount of interest withdrawn from the account. In sum and substance, the debt (which includes both interest and principal)[23] has not been discharged, canceled, or forgiven. The penalty or forfeiture was an obligation of the depositor, which petitioner and depositor agreed, in advance, could be satisfied from interest credited or principal deposited in the account.

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[20] The certificates issued by petitioner contained "Penalty Clause Sections[s]" and the text of these sections referred to a "penalty," whereas the DIDC regulations refer to a "forfeiture." The parties have used the terms "penalty" and "forfeiture" interchangeably in their stipulation of facts and briefs and we have not placed any significance upon the use of these particular terms.

[21] Up until Sept. 4, 1979, and for all prior years, petitioner reduced the gross amount of interest shown in depositors' accounts by the amount of penalties or forfeitures for the same period. Following Sept. 4, 1979, through the conclusion of its taxable year ended June 30, 1980, petitioner did not reduce the gross amount of interest reflected in depositors' accounts by the amount of forfeitures for that same period. This change in approach by petitioner coincides with the change in the regulations, to some extent, as reflected in note 6, *supra*. In any event, petitioner contends that its treatment of the forfeitures prior to Sept. 4, 1979, was in error.

[22] See note 16, *supra*.

[23] The parties agree that both interest and principal in the accounts are the basis for a debtor-creditor relationship between the petitioner and depositors.

Respondent has treated consistently the subject of premature withdrawal in regulations and rulings. The obligation to supply depositors with annual information returns, Forms 1096 and 1099–INT, was published in 1973 and required institutions to reflect the full or gross amount of interest credited or paid, unreduced by any penalty or forfeiture for premature withdrawal. Rev. Rul. 73–511, 1973–2 C.B. 402, 403. The rationale of that ruling, in part, relied upon the difference in treatment of the penalty by recipients. In effect, the interest credited was income to the depositor and the penalty deductible as a loss under section 165. If incurred in a trade or business, the loss may be a deduction from gross income, but for some taxpayers the loss may be available only if deductions are itemized. The regulations under section 1017, which were originally filed in 1956, treat payments in kind as discharges affecting basis only to the extent that the value of the payment was less than the reduction of the indebtedness. Sec. 1.1017–1(b)(5), Income Tax Regs.

The need for relief from (deferral of) income from discharge of indebtedness, congressionally considered in the enactment of sections 108 and 1017 and their predecessors, is not present in this case. Here, petitioner's relief would seem to be the penalty for early withdrawal received from the depositor. Petitioner has had the use of depositors' funds, a full tax deduction for interest credited and not necessarily paid,[24] and a penalty to compensate petitioners for any hardship caused by the early withdrawal. In comparison to the *Kirby* principle, there has not been an increase in the value of assets attributable to a reduction in liabilities. In this case, petitioner has been compensated by depositors' payments of penalties. *Estate of Delman v. Commissioner, supra*; *OKC Corp. & Subsidiaries v. Commissioner, supra*; *Spartan Petroleum Co. v. United States, supra*.

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[24] Because a certificate may not mature prior to the end of petitioner's taxable year, petitioner may have enjoyed some deferral without secs. 108 and 1017. The penalty may fall into a subsequent year and not have the tax effect of "washing out" in the same taxable period.

Petitioner cites three cases in support of its position. One of these cases has a factual pattern with some similarities to this case. In *Reliable Incubator & Brooder Co. v. Commissioner*, 6 T.C. 919, 926–927 (1946), the taxpayer was obligated to make $50 monthly payments toward an outstanding and fixed obligation approximating $6,700. At at time when the taxpayer's creditor was in need of money, the parties agreed to reduce the outstanding debt by $1,200 in exchange for a $600 payment by the taxpayer in advance of the monthly due dates. On these facts we decided that there was $600 of income from discharge of indebtedness to the taxpayer, but that the deferral relief was not available because of the taxpayer's failure to file a consent and the taxpayer was not insolvent or in an "unsound financial condition."[25] Although petitioner in this case has filed a timely and proper consent. the facts of this case do not coincide with those in *Reliable Incubator*. Petitioner here was indebted for interest (and principal) and part or all of its indebtedness was "paid" or offset by the depositors' obligation for a penalty attributable to premature withdrawal. Stated another way, the debtor's accumulated interest was essentially used to pay the penalty on a dollar-for-dollar or par basis. The parties in *Reliable Incubator* entered into a "two-for-one" reduction in indebtedness so that each dollar paid provided an additional "dollar of forgiveness" of the debt. Only the additional dollar or credit (the "forgiveness dollar") was found to be income from discharge of indebtedness. *Reliable Incubator & Brooder Co. v. Commissioner*, 6 T.C. 919, 926–927. To the same effect, petitioner has cited a Memorandum Opinion of this Court which followed *Reliable Incubator*. *San Marcos Hotel Co. v. Commissioner*, a Memorandum Opinion of this Court dated April 18, 1852. A third and final case cited by petitioner falls in a similar category with *Reliable Incubator* because it involves a conversion of debt into equity instruments and accrued interest was disregarded at the time of conversion. *Columbia Gas Systems, Inc. v. United States*, 473 F.2d 1244, 1249–1250 (2d Cir. 1973). The issuer of the debt was found to have income from discharge of indebtedness to the extent of interest disregarded at the time of conversion. Again, unlike the facts in the case before us, the disregarding of the interest at the time of conversion represents a classic application of *Kirby*. Although it could be said that the parties bargained for that result, there is no indication that the bondholder received or was relieved of anything in exchange for the discharged indebtedness.

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[25] The "unsound financial condition" requirement was removed in 1942.

We understand and do not disapprove of petitioner's attempt herein to arrange its tax matters efficiently and seek deferral of the income from the depositors' penalties. We find, however, that the facts herein do not support the result petitioner seeks.

In view of the foregoing,

An appropriate order will be entered finding for the respondent on the issue presented in this case

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KENNETH P. GRISWOLD AND FLORINE GRISWOLD, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 9370–84. Filed November 26, 1985.

During the year in issue, petitioner-husband was the owner of an annuity contract issued by JH, an insurance company. On July 1, 1980, petitioner-husband entered into a loan transaction with JH pursuant to which he borrowed against the loan value of the annuity. At the time of such borrowing, the annuity qualified as an individual retirement annuity, as defined in sec. 408(b), I.R.C. 1954. *Held*: Petitioner-husband's borrowing from JH was a borrowing under or by use of an individual retirement annuity. Under sec. 408(e)(3), the annuity ceased to qualify as an individual retirement annuity as of Jan. 1, 1980, and petitioners must include in gross income for such year the fair market value of the annuity as of that date.

Louis J. McCoy, for the petitioners.
John C. Schmittdiel, for the respondent.

OPINION

FAY, *Judge*: Respondent determined a deficiency of $3,787 in petitioners' 1980 Federal income tax. After concessions, the sole issue is whether, under section 408(e)(3),[1] petitioner Kenneth P. Griswold's borrowing against an annuity contract during 1980 caused such contract to cease being an individual retirement annuity and required petitioners to include in their gross income for 1980 the fair market value thereof.

The facts have been fully stipulated and are so found.

Petitioners Kenneth P. Griswold and Florine Griswold are husband and wife. They resided in St. Paul, Minn., at the time they filed the petition herein.

During the year in issue, petitioner Kenneth P. Griswold (herein petitioner) was the owner of an annuity contract with John Hancock Mutual Life Insurance Co. (herein John Hancock). The fair market value of this contract as of January 1, 1980, was $6,866.

On July 1, 1980, petitioner obtained a loan from John Hancock by borrowing against the loan value of the annuity contract.[2] At the time of this borrowing, the annuity contract satisfied the requirements set forth in section 408(b), and thus was an individual retirement annuity within the meaning of that section. Petitioner had been advised by a representative of John Hancock that such borrowing was without income tax consequences so long as the loan was repaid. Petitioner repaid the loan in full prior to April 15, 1981.

In late June or early July of 1981, petitioner received a check from John Hancock in the amount of $8,510.27, representing the entire balance of his annuity contract. On July 21, 1981, petitioner reinvested the entire amount received from John Hancock with Delaware Charter Guaranty & Trust Co. through Piper, Jaffray & Hopwood, Inc.

In his notice of deficiency, respondent determined that, by reason of petitioner's borrowing against the individual retirement annuity contract, petitioners were required under section 408(e)(3) to include in their gross income for 1980 the sum of $6,866, representing the fair market value of such contract as of January 1, 1980. Respondent also made several other adjustments concerning petitioners' Federal income tax liability, as to which the parties have reached agreement. Thus, the sole remaining issue is whether, under section 408(e)(3), petitioner's borrowing against the annuity contract caused such contract to cease being an individual retirement annuity and required petitioners to include in gross income for 1980 the value of such contract as of January 1, 1980.[3]

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[1] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

[2] The record does not reflect the amount of this loan.

Individual retirement annuities, like individual retirement accounts, are a form of tax-favored retirement savings arrangement.[4] The rules governing their taxability are generally contained in section 408. As relevant herein, section 408(d)(1) sets forth the general rule that amounts paid or distributed under an individual retirement annuity shall be included in gross income for the taxable year in which the payment or distribution is received. The owner of an individual retirement annuity thus is generally not taxed with respect thereto until amounts are received by him under the annuity contract. Cf. sec. 408(d)(1), sec. 1.408–4(a), Income Tax Regs.[5]

However, an exception to this general rule is contained in section 408(e)(3), which provides as follows:

> (3) EFFECT OF BORROWING ON ANNUITY CONTRACT.—If during any taxable year the owner of an individual retirement annuity borrows any money under or by use of such contract, the contract ceases to be an individual retirement annuity as of the first day of such taxable year. Such owner shall include in gross income for such year an amount equal to the fair market value of such contract as of such first day.

Section 1.408–3, Income Tax Regs., sets forth rules pertaining to individual retirement annuities. Of particular relevance herein is section 1.408–3(c), Income Tax Regs., which provides as follows:

> (c) DISQUALIFICATION.—If during any taxable year the owner of an annuity borrows any money under the annuity or endowment contract or by use of such contract (including, but not limited to, pledging the contract as security for any loan), such contract will cease to be an individual retirement annuity as of the first day of such taxable year, and will not be an individual

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[3] We note that petitioners have not filed either an original brief or a reply brief in this case.

[4] The statutory provisions relating to individual retirement annuities and individual retirement accounts were first introduced with the enactment of the Employee Retirement Income Security Act of 1974, Pub. L. 93–406, 88 Stat. 829. See H. Rept. 93–807, at 126–127, 1974–3 C.B. (Supp.) 236, 361–362. Conf. Rept. 93–1280. at 335–336, 1974–3 C.B. 415, 496–497. See generally *Orzechowski v. Commissioner*, 69 T.C. 750, 752–753 (1978), affd. 592 F.d 677 (2d Cir. 1979). See also the discussion at note 6 and accompanying text, *infra*.

[5] See also H. Rept. 93–807, at 135 note 11, 1974–3 C.B. (Supp.) 236, 370 note 11, which indicates "As with annuities generally [sic] the owner of an individual retirement annuity is not to be currently taxed on the annual increased value of the annuity, but is taxed on receipt of annuity payments."

> retirement annuity at any time thereafter. If an annuity or endowment contract which constitutes an individual retirement annuity is disqualified as a result of the preceding sentence, an amount equal to the fair market value of the contract as of the first day of the taxable year of the owner in which such contract is disqualified is deemed to be distributed to the owner. Such owner shall include in gross income for such year an amount equal to the fair market value of such contract as of such first day. The preceding sentence applies even though part of the fair market value of the individual retirement annuity as of the first day of the taxable year is attributable to excess contributions which may be returned tax-free under section 408(d)(4) or 408(d)(5).

Under the clear language of section 408(e)(3) and section 1.408–3(c), Income Tax Regs., the owner's borrowing under or by use of an individual retirement annuity is a disqualifying event having two distinct consequences. First, it causes the annuity contract to cease being an individual retirement annuity as of the first day of the taxable year in which such borrowing occurs. Thus, as of such date, the annuity contract ceases to be eligible for the favorable tax treatment generally accorded to individual retirement annuities. Second, an amount equal to the fair market value of such contract on the first day of the taxable year in which the borrowing occurs is deemed distributed to the owner, who is required to include such amount in gross income for such taxable year.

Application of these principles to the facts of the instant case requires a holding for respondent. During 1980, petitioner was the owner of an annuity contract with John Hancock. On July 1, 1980, petitioner obtained a loan from John Hancock by borrowing against the loan value of the annuity contract. At the time of such borrowing, the contract satisfied the requirements set forth in section 408(b) and thus was an individual retirement annuity within the meaning of that section. We conclude that the loan from John Hancock to petitioner was a borrowing under or by use of an individual retirement annuity. Accordingly, we hold under section 408(e)(3) that the borrowing caused petitioner's annuity contract to cease being an individual retirement annuity as of January 1, 1980, and that petitioners must include in their gross income for 1980 the sum of $6,866, representing the fair market value of the annuity contract with John Hancock as of January 1, 1980.

Our conclusion is supported not only by the express language of the statute and the regulations, but also by the legislative history relating to the Employee Retirement Income Security Act of 1974, Pub. L. 93–406, 88 Stat. 829 (herein ERISA) as part of which section 408 was enacted into law. In adopting the individual retirement provisions of ERISA,[6] Congress' goal was to create a system whereby employees and self-employed persons not covered by qualified retirement plans would have the opportunity to set aside at least some retirement savings on a tax-sheltered basis. See H. Rept. 93–807, at 126, 1974–3 C.B. (Supp.) 236, 361; S. Rept. 93–383, at 131, 1974–3 C.B. (Supp.) 80, 210. Under the statutory framework thus established, individuals could obtain a deduction for amounts contributed to individual retirement accounts, individual retirement annuities and individual retirement bonds, and earnings on such amounts could accrue tax free. See secs. 219, 408, 409. See also H. Rept. 93–807, *supra* at 126–127, 1974–3 C.B. (Supp.) at 361–362; S. Rept. 93–383, *supra* at 130–131, 1974–3 C.B. (Supp.) at 210; *Orzechowski v. Commissioner*, 69 T.C. 750, 752–753 (1978), affd. 592 F.2d 677 (2d Cir. 1979).

In adopting this statutory framework, Congress intended that funds contributed to an individual retirement account, individual retirement annuity, or individual retirement bond be used for retirement purposes. Accordingly, it sought to discourage certain transactions which would circumvent this statutory purpose. See H. Rept. 93–807, *supra* at 127, 138, 1974–3 C.B. (Supp.) at 362, 373; cf. S. Rept. 93–383, *supra* at 134, 1974–3 C.B. (Supp.) at 213. One such transaction, which it sought to prevent by means of section 408(e)(3), was the borrowing under or by means of an individual retirement annuity. The House Ways and Means Committee described the consequences of such a borrowing as follows:

> With respect to individual retirement annuities (which are nontransferable and cannot be hypothecated), the bill prohibits the owner of the contract from borrowing money from the insurance company issuing the contract, under or by use of the contract. If any prohibited borrowing occurs, (regardless of the amount involved) the contract is to lose its qualification as an individual retirement annuity as of the first day of the taxable year of the contract owner in which the borrowing occurs. In this case, the owner is to include in income for that year the fair market value (which may or may not

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[6] See sec. 2002 of Pub. L. 93–406, 88 Stat. 958–971, which added secs. 219, 408, 409, 4973, 4974, and 6693.

> be the same as the cash surrender value) of the contract as of the first day of that year. Since the owner's basis in the contract is to be zero the entire amount deemed distributed is to be taxable to him as ordinary income. * * * (If the annuity contract is sold, exchanged or hypothecated, in violation of its terms, it is intended that the same consequences will occur as with a prohibited borrowing from an insurance company.) [H. Rept. 93-807, *supra* at 136-137, 1974-3 C.B. (Supp.) at 236, 371-372. See also Conf. Rept. 93-1280, at 339, 1974-3 C.B. 415, 500.][7]

The foregoing excerpt from the legislative history of section 408(c)(3) makes it clear that petitioner's borrowing from John Hancock against his annuity contract was precisely the type of transaction which Congress sought to discourage by means of that statutory provision.

A contrary holding is not required by the parties' stipulation that petitioner received the balance of his annuity contract from John Hancock in July 1981 and reinvested the proceeds thereof within 60 days. It is true that under section 408(d), certain amounts paid under an individual retirement annuity will not be includable in gross income if they are, within 60 days of receipt, reinvested in a "rollover" transaction as prescribed in that section. See secs. 408(d)(1), 408(d)(3). However, petitioners can take no comfort in this section. First, the record does not establish that the reinvestment of the proceeds was made in the manner prescribed by section 408(d)(3). Furthermore, insofar as is relevant herein, section 408(d) applies only to amounts paid out of or distributed under an individual retirement annuity. See secs. 408(d)(1), 408(d)(3). We have held, however, that petitioner's borrowing against the annuity contract with John Hancock on July 1, 1980, caused such contract under section 408(e)(3) to cease being an individual retirement annuity as of January 1, 1980. Thus, after giving effect to section 408(e)(3), those statutory provisions which relate to individual retirement annuities, such as section 408(d), can have no application with respect to petitioner's annuity contract on or after January 1, 1980.

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[7] While the legislation history does not expressly so indicate, it is inferable therefrom that a borrowing against an individual retirement annuity would frustrate the statutory purpose in that it would allow the owner to, in effect, have the use of the retirement funds prior to his retirement. Such a borrowing could leave the owner without funds for retirement, a result which Congress clearly sought to discourage. Cf. H. Rept. 93-807, *supra* at 138, 1974-3 C.B. (Supp.) at 373; S. Rept. 93-383, at 134, 1974-3 C.B. at 213.

Thus, we hold that under section 408(e)(3), petitioner's borrowing against the annuity contract with John Hancock during 1980 caused the contract to cease being an individual retirement annuity as of January 1, 1980. Under the provisions of that section, petitioners are required to include in their gross income for 1980 the sum of $6,866, representing the fair market value of such contract as of January 1, 1980.[8]

To reflect concessions and the foregoing,

Decision will be entered under Rule 155.

JERROLD L. McKENZIE AND SALLY A. McKENZIE, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 670–82. Filed November 27, 1985.

Ps claimed investment tax credits with respect to their dog and cat kennel and horse barn. The kennel had a boarding area specifically designed for the temporary boarding of dogs, the design of which facilitated sanitation needs and animal comfort. The horse barn was a general purpose "Lester" building, the design of which Ps varied for their Arabian horse breeding and showing activities. The horse barn could economically be used for other purposes.

Held, the kennel is not a single purpose agricultural or horticultural structure within the meaning of sec. 48(a)(1)(D) and sec. 48(p), I.R.C. 1954.

Held, further, the boarding area portion of the kennel is not "a structure which is essentially an item of machinery or equipment" under sec. 1.48–1(e)(1), Income Tax Regs., and thus is not "tangible personal property" under sec. 48(a)(1)(A), I.R.C. 1954.

Held, further, the boarding area portion of the kennel is an inherently permanent structure within the meaning of sec. 1.48–1(c), Income Tax Regs., and thus is not "tangible personal property" under sec. 48(a)(1)(A), I.R.C. 1954. *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975), applied.

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[8] Our holding is not affected by the fact that petitioner engaged in the borrowing herein in reliance upon the erroneous advice of a representative of John Hancock. By means of the clear language of sec. 408(e)(3), Congress has prescribed the consequences of a borrowing under or by use of an individual retirement annuity, and we must apply the law as so written.

Held, further, Ps' horse barn was not specifically designed and constructed for housing, raising, and feeding a particular type of livestock within the meaning of sec. 48(p)(2), I.R.C. 1954, and sec. 1.48–10(d), Income Tax Regs., and thus is not a qualifying single purpose agricultural or horticultural structure under sec. 48(a)(1)(D) and sec. 48(p), I.R.C. 1954.

Held, further, Ps' horses are not livestock within the meaning of sec. 48(p)(2), I.R.C. 1954, and sec. 1.48–10(b)(3), Income Tax Regs. Validity of regulation upheld.

John P. Raynor, for the petitioners.
Robert L. Archambault, for the respondent.

PARKER, *Judge*: Respondent determined deficiencies in petitioners' Federal income taxes in the amounts of $1,510 and $890 for the taxable years 1973 and 1976, respectively. Respondent also denied petitioners' refund claim asserted in amended returns filed for 1973 and 1976, and petitioners now assert on overpayment of taxes in that regard. On their original and amended returns, petitioners claimed investment tax credits, which give rise to various issues under the statute and regulations governing such credits.

The issues for decision are as follows:

1. Whether petitioners' dog and cat kennel is a single purpose agricultural or horticultural structure within the meaning of section 48(a)(1)(D).[1] Specifically, the issue is whether the kennel qualifies as a single purpose livestock structure under section 48(p)(2).

2. If not, whether the boarding area of that kennel is "tangible personal property" as that term is used in section 48(a)(1)(A). That in turn involves issues under the pertinent regulations as to whether or not the boarding area is an inherently permanent structure and whether or not the boarding area is an item of machinery or equipment.

3. Whether petitioners' horse barn is a single purpose agricultural or horticultural structure within the meaning of section 48(a)(1)(D). That involves issues as to whether the structure was specifically designed, constructed, and used as a single purpose livestock structure under section 48(p)(2), and

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable years in question, and all "Rule" references are to the Tax Court Rules of Practice and Procedure.

whether horses are livestock within the meaning of section 48(p)(2) and section 1.48–10(b)(3), Income Tax Regs.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The written and oral stipulations of facts and the exhibits attached to the written stipulation are incorporated herein by this reference.

Petitioners Jerrold L. McKenzie and Sally A. McKenzie, husband and wife, resided at 12104 Capehart Road, Papillion, Nebraska, at the time they filed their petition in this case. Petitioners filed 1973 and 1976 joint Federal income tax returns (Forms 1040) and amended 1973 and 1976 returns (Forms 1040X) with the Internal Revenue Service Center in Ogden, Utah.

I. The Kennel Facility

Pursuant to an Omaha Board of Realtors Uniform Purchase Agreement dated February 17, 1976, petitioner Jerrold L. McKenzie purchased 11.8 acres of land with improvements thereon, located at 12104 Capehart Road, Papillion, Nebraska. The total purchase price for the property was $100,000. Improvements on the property included a residence, a dog and cat kennel (the kennel facility), and a small shed. The uniform purchase agreement does not contain any allocation of the $100,000 purchase price between the land and the improvements, or among the various improvements. The parties stipulated that $24,000 of the $100,000 purchase price is allocable to the kennel facility.[2]

The kennel facility constitutes real property under State law. The kennel facility is principally a concrete and cinder-block structure enclosing approximately 1,350 square feet. The walls are approximately 8 feet tall and are imbedded in a concrete foundation. It is a permanent structure fixed to the ground with a foundation. The facility could not be moved without destruction of the property. It is basically a facility for temporarily boarding pet dogs and cats while their owners are absent. Petitioners have never used the kennel facility for any other purpose.

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[2] Petitioners offered the uniform purchase agreement into evidence to show that it contained no allocation of the purchase price to the kennel facility and that the stipulated cost allocation was based on respondent's acceptance of petitioner's allocation. Petitioners suggested that this would lend some credibility to Jerrold L. McKenzie's testimony regarding the allocation of costs among various parts of the kennel facility. See note 5 and accompanying text, *infra*. Respondent objected to the admission of the uniform purchase agreement into evidence because it does not in any way suggest a proper allocation of the purchase price between the land and improvements, among the various improvements, or among various parts of the kennel facility. The document was admitted into evidence with the understanding that it does not contain any allocation of the total purchase price. See Rule 41(b)(2); notes 5, 8, and 23, and accompanying text, *infra*.

The kennel facility consists of two principal areas, the "front structure" and the "boarding structure." These two areas would be separate structures if they did not share a common wall. They have separate roofs attached to their respective walls. The front structure measures 30.5 feet in width by 15.5 feet in depth, or approximately 473 square feet. Just inside the front door to the front structure are the reception and office areas. The reception and office areas are separated by an "L" shaped counter that encloses the office area. When a customer comes in to leave his pet, he fills out the necessary paperwork on the front part of the counter. Such paperwork includes a general release form and an information sheet on which the customer states, inter alia, the pet's food and medication requirements, its veterinarian, and its anticipated length of stay. Petitioners prepare the food to be served to the boarded pets on the side part of the counter. Petitioners also use the top of the counter to store the individual medications required by the boarded animals.

To the right of the counter and the reception area is a food storage area. During 1976, petitioners used this area to store large quantities of dog food. They bought large quantities of dog food at a wholesale rate, and then sold much of it to their customers. This enabled petitioners to reduce their cost of feeding the dogs they boarded. These sales took place in the reception area. Petitioners no longer purchase and store large quantities of dog food. They now use the food storage area to store smaller quantities of dog food and as a place to put temporary cages to keep animals when they have an overflow of animals to be boarded. Petitioners intend to install between 5 and 10 permanent cat cages in the food storage area.

To the left of the reception and office areas is a separate room known as the cat room. Cages used to board cats are located in the cat room. Two or three times a day petitioners clean these cages and the litter boxes in them, and change the cats' water. Petitioners feed the cats twice a day. A bathtub raised to waist level is also located in the cat room. Petitioners bathe boarded animals in the tub. An animal is bathed at its owner's request, if it gets extremely dirty, and/or before it is returned to its owner. Petitioners also use the tub to wash the dishes used to feed the boarded animals. Petitioners have never used the cat room for any other purpose. There is also a small bathroom in the cat room for petitioners' use.

Petitioners board dogs in the rear part of the kennel facility (the boarding structure). The boarding structure is 60 feet long and approximately 14.5 feet wide. It encompasses approximately 877 square feet.[3] A door in the wall common to the front structure and the boarding structure opens from the office area directly into the boarding structure. A concrete aisle approximately 4 feet in width runs down the center of the boarding structure from the office door to the far end of the boarding structure. The aisle provides access to 37 individual dog pens (the inside runs) that run down both long walls of the boarding structure. Each inside run is 4 feet long (measuring from the outer wall of the boarding structure in towards the center aisle). The inside runs vary from 2½ to 4 feet in width.[4]

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[3] The parties stipulated that the entire kennel facility measures approximately 1,350 square feet. According to a floor plan admitted into evidence, the front structure measures 30.5 feet by 15.5 feet. These measurements yield 472.75 or approximately 473 square feet. The floor plan also clearly shows that the boarding structure is 60 feet in length. It does not, however, disclose the exact width of the structure. Two different estimates of the boarding structure's width can be made using other measurements provided by the floor plan and Mr. McKenzie's testimony. The floor plan shows that a fence surrounds the boarding structure. The length of the fence running parallel with the end of the boarding structure is 42 feet. The distance between the long sides of the structure and the fences running parallel with them is 14 feet on each side. These figures produce a 14-foot estimate of the boarding structure's width (42-foot end fence length, less 2 times the 14-foot distances between the long side fences and the long sides of the boarding structure, equals 14). However, dog pens that line the inside of the long walls of the boarding structure are 4 feet deep. A center aisle that runs down the middle of the boarding structure, thus separating the pens on either side, is approximately 4 feet wide. Adding these measurements, the width of the boarding structure is estimated to be 12 feet (2 times 4-foot pen depths on either side, plus 4-foot width of the aisle, equals 12). This estimate does not take into account the width of gutters that run along either side of the center aisle in front of the inside pens. Respondent requested that we find as a fact that the boarding area measured 60 feet long by 12 feet wide. Petitioners requested that we find that the boarding structure measures approximately 877 square feet. To give effect to the parties' stipulation that the entire kennel facility measures approximately 1,350 square feet, we must find that the boarding structure measures approximately 877 square feet (1,350 less 473 (square footage of the front structure) equals 877). Sixty feet times the first estimate above of 14 feet equals 840 square feet. Sixty feet times the second estimate above of 12 feet equals 720 square feet. Sixty feet times 14.5 feet equals 870 square feet. Thus, we find as a fact that the boarding structure is *approximately* 14.5 feet wide and contains *approximately* 877 square feet. The 877 square feet does not include the outside runs for each inside pen.

[4] The parties so stipulated. However, according to the floor plan of the boarding structure, at least three of the inside runs are double runs 5 feet wide.

Each inside run is separated from the runs on either side of it by a concrete wall that is 4 feet tall. The top of each inside run is enclosed with chain-link fencing. The front of each inside run (i.e., the side facing the center aisle) consists of a chain-link fence gate.

Gutters run the length of the boarding structure on either side of the center aisle, in front of each row of inside runs. The gutters run into large drains at the south end of the boarding structure (the end adjoining the front structure). The concrete floors of the inside runs slope to the center of the boarding structure so that water runs into the gutters and then to the drains. The center aisle is crowned (i.e., higher in the middle than on the sides) so that water on it also runs into the gutters.

The boarding structure is heated by overhead heaters and cooled with air-conditioning for animal comfort. Additionally, radiant floor heaters are embedded in the concrete floors of the inside runs so that the concrete floors are not too cold for the animals to lie or sleep on. The boarding structure is also fully equipped with plumbing and electricity.

A dog in an inside run can gain access to a corresponding pen outside the boarding structure (an outside run) through a 12-inch by 17-inch opening or doorway in the wall of the boarding structure that forms the back of the inside run. This opening is usually covered by a rubber flap so that a dog can generally go in or out as it pleases. However, the doorway can also be closed by a metal guillotine-type door. A cable that extends out to the center aisle is attached to the door. Thus, a worker standing in the center aisle can open the doorway by pulling on the cable and raising the door straight up along its tracks, or close the doorway by releasing the cable and lowering the door.

The outside runs are 8 feet long (measuring from the wall of the boarding structure out) and are generally the same width as the corresponding inside run. The sides and top of each outside run consist of chain-link fencing. The front of each outside run is a chain-link-fence gate. On either side of the boarding structure, a gutter the length of the structure runs in front of the row of outside runs. These gutters run into drains at the south end of the structure. The concrete floors of the outside runs slope away from the boarding structure so that water runs into the outside gutters. The boarding structure is completely surrounded by a concrete sidewalk and a 6-foot-tall chain-link fence. The posts of this chain-link fence are embedded in concrete.

The floors of the inside and outside runs are sloped, and the center aisle in the boarding structure is crowned to permit easy removal of animal waste material. When the runs are washed, waste material runs into the gutters and then into the drains at the south end of the boarding structure. The center aisle of the boarding structure allows petitioners access to the inside runs so that they can put dogs in and take dogs out of the runs. It also allows petitioners to water and feed the animals in the runs. The guillotine-type door in the doorway between each inside and outside run keeps the dog in the inside run while the outside run is being cleaned, and vice versa. It also keeps dogs inside during inclement weather. The sidewalk surrounding the boarding structure serves as a backside to the gutters that run in front of the outside runs. If the sidewalk were not there, waste material would accumulate in the area it covers because waste material frequently washes up out of the gutters and onto the sidewalk when the outside runs are cleaned. The sidewalk also provides an exercise area for the dogs that can be easily cleaned. Without the sidewalk and gutters, waste material left by dogs during their exercise would be difficult to completely remove.

Because the dogs and cats petitioners board are in such close quarters, it is easy for diseases and parasites to quickly spread among them. When an outbreak of a disease or parasites among the animals occurs, petitioners must completely disinfect the entire boarding structure. To do that, petitioners must stop taking animals about a month in advance so that there are no animals in the structure when it is disinfected. Petitioners have had two outbreaks of parainfluenza among boarded dogs. Such outbreaks and the shutdowns for disinfecting that follow can be very detrimental to petitioners' kennel business. Consequently, the expedient removal of waste material and the maintenance of sanitary conditions are of utmost importance to petitioners' kennel operations. They wash each run, inside and outside, with water each day, weather permitting. After a dog is picked up by its owner, petitioners wash the run it occupied with water. They then clean the run with a disinfectant soap and rinse it with water again. Finally, they spray the run with a disinfectant.

The chain-link fence surrounding the boarding structure is there primarily for security purposes. It prevents a dog that is being exercised outside of its run or that somehow gets out of its run from escaping from the kennel facility grounds. It also keeps out people who do not belong on the grounds so that they cannot steal the dogs or be injured by the boarded animals.

Petitioners have never used the kennel facility for any purpose other than boarding animals. The facility could not be economically used for any other purpose.

In 1980, petitioner Jerrold L. McKenzie investigated the possibility of expanding the boarding structure and adding more runs. He has not expanded the structure because it is cost prohibitive. In making the investigation, he determined that the cost of replacing the chain-link fencing throughout and surrounding the structure would be $13,000. Without any explanation as to the nature of his investigation or as to his methodology, Mr. McKenzie concluded he would allocate one-third of the $24,000 cost allocated to the entire kennel facility (by the parties' stipulation), or $8,000, to such fencing.[5] He further concluded he would allocate 75 percent of the $24,000 cost allocated to the kennel facility, or $18,000, to the boarding structure (including the fencing). See note 5. There is no competent, probative evidence to support these estimates.

II. The Horse Barn

During November of 1976, petitioners constructed a horse barn on their Capehart Road property. The construction was completed by the first of December. The horse barn is a clear span metal structure measuring 44 feet by 100 feet. Petitioners spent $12,204 to construct the horse barn.

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[5] The Court admitted Mr. McKenzie's testimony in this regard over a number of objections raised by respondent. Respondent raised a continuing objection to any testimony regarding a cost allocation among parts of the kennel facility because he thought that such an allocation was not an issue properly before the Court. See Rule 41(b)(2); note 8, *infra*. Respondent also objected to such testimony because he thought that the cost of replacing existing fencing with new fencing in a year subsequent to the taxable years in issue is irrelevant in determining the proper allocation of the actual cost of the kennel facility among its components, especially when the facility was purchased used. The Court agrees with respondent that such replacement costs are irrelevant. Moreover, there is nothing in the record to support Mr. McKenzie's testimony except his own ipse dixit to which the Court accords little weight. These figures appear to have been plucked out of thin air and are entitled to about the same weight.

The horse barn is a "Lester" general purpose design building. In constructing the barn, petitioners made a number of alterations to the Lester design. Petitioners added a 4-foot overhang to the southern end of the roof so that they can walk to the barn or around the barn when it is raining without getting wet. Petitioners put eight windows in the barn to provide adequate ventilation. They also made the walls 12 feet tall (which is higher than the Lester design) so that a person can sit on a horse inside the barn and not hit his head on the rafters. After petitioners initially built the horse barn, they added two additional doors to the east side to allow horses to enter and exit.

However, during 1976 petitioners made no interior improvements to the barn, and its interior was just a big open space. In inclement weather, they used the barn to ride and exercise the five Arabian horses they owned at that time. They also kept the horses in the barn for short periods of time during extremely bad weather. In the spring of 1977, petitioners started making a series of improvements inside the barn. First, they put in three permanent horse stalls along the east wall at the south end of the barn. Then they built three stalls along the west wall directly opposite the first three stalls. Next, petitioners installed hay storage areas up above the first six stalls. At this point, the stalls, a washroom, and a tackroom occupied the southern two-fifths of the barn. The remaining three-fifths of the interior was an open space used for exercising horses. The floor of this open space was filled with fill sand for soft footing. The floor in the other area was just dirt, except that sawdust was used as bedding in the stalls.[6] Subsequently, petitioners increased the number of horses they owned, so they had to put in more stalls. First, they added two more permanent stalls. Then, they put in four portable metal stalls. They also had one temporary stall in the barn. Petitioners have also increased their hay storage space. Because of the additional stalls, petitioners now have to exercise their horses in the aisleway separating the two rows of stalls.

Petitioners also use areas in the barn for grain and sawdust storage. Petitioners intend to build a wash area for washing and grooming horses where they now store grain. They also hope to build a veterinarian service area with a concrete floor, central drain, and heating system. Finally, they intend to install a tackroom for saddle, equipment, and medicine storage where the temporary stall is now located. Petitioners erected the horse barn intending to eventually make all of these improvements. They have made the improvements as they could afford them.

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[6] The record does not indicate what the floor was made of during 1976, before the stalls were put in.

Petitioners have never used the horse barn for anything other than housing, raising, exercising, and caring for the Arabian horses they breed, raise, show, and sell. Petitioners do not store any equipment in the barn. All of the human activity that occurs in the barn relates to the feeding, cleaning, bathing, breeding, and general care of petitioners' horses. The horse barn could economically be adapted to other uses by merely removing the stalls and other fixtures petitioners have put in.

On the Form 3468 (Computation of Investment Credit) attached to their 1976 return, petitioners claimed a $2,590 investment credit. Of that amount, $2,400 was attributable to petitioners' investment in the kennel facility. Petitioners applied $890 of the credit claimed for the kennel facility against their 1976 income tax liability and applied the remaining $1,510 as an investment credit carryback against their 1973 income tax liability. On the Schedule F (Farm Income and Expenses) attached to their 1976 return, petitioners reported gross receipts in the amount of $5,204 from dogfood sales. On part III (Depreciation) of the Schedule F, petitioners claimed a depreciation expense on the kennel facility in the amount of $600. That amount was calculated using the full $24,000 cost basis of the facility, with no allocation between land and improvements thereon. No other assets related to the kennel facility appear on the depreciation schedule. For depreciation purposes, petitioners did not allocate the facility's basis to its various components.

On or about July 31, 1979, petitioners filed amended returns for 1973 and 1976. On the amended 1976 return petitioners claimed an additional investment credit in the amount of $1,220 for their investment in the horse barn. On the amended 1973 return, petitioners claimed a refund in the amount of $532 attributable to a carryback of the investment credit claimed on the horse barn.

By a statutory notice of deficiency dated October 15, 1981, respondent disallowed the $2,400 investment credit and resulting carryback petitioners claimed for the kennel facility. Respondent also disallowed the $1,220 investment credit and resulting carryback petitioners claimed for the horse barn. Petitioners challenge those disallowances and claim an overpayment of taxes for 1973.

OPINION

During the taxable year 1976, section 38 allowed a credit against Federal income taxes for qualified investment in section 38 property.[7] Section 48(a) defined the term "section 38 property." As amended by section 314 of the Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2763, 2827–2828, 1978–3 C.B. (Vol. 1) 61–62, which amendment was made applicable to taxable years ending after *August 15, 1971*, section 48(a) defined section 38 property as follows:

> SEC. 48(a). SECTION 38 PROPERTY.—
>
> (1) IN GENERAL.—Except as provided in this subsection, the term "section 38 property" means—
>
> (A) *tangible personal property*, or
>
> (B) other tangible property (not including a building and its structural components) but only if such property—
>
> (i) is used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or
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> * * * * * * *
>
> (D) *single purpose agricultural or horticultural structures*; or
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> * * * * * * *

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[7] During the taxable year in question, sec. 38 provided as follows:

> SEC. 38. INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.
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> (a) GENERAL RULE.—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.
>
> (b) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B.

The substantive rules for computing the credit were in secs. 46 through 50 (subpart B). Sec. 38 and secs. 46 through 50 were substantially reorganized and revamped by various sections of the Tax Reform Act of 1984, Division A of the Deficit Reduction Act of 1984, Pub. L. 98-369, 98 Stat. 494, 1984–3 C.B. (Vol. 1) 2, generally effective for taxable years beginning after Dec. 31, 1983, and for carrybacks from such years.

> Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 3 years or more.
>
> [Emphasis added.]

Section 314 of the Revenue Act of 1978, *supra*, also added section 48(p) to the Code, which provides as follows:

> SEC. 48(p). SINGLE PURPOSE AGRICULTURAL OR HORTICULTURAL STRUCTURE DEFINED.—For purposes of this section—
>
> (1) IN GENERAL.—The term "single purpose agricultural or horticultural structure" means—
>
> (A) a single purpose livestock structure, and
>
> (B) a single purpose horticultural structure.
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> (2) SINGLE PURPOSE LIVESTOCK STRUCTURE.—The term "single purpose livestock structure" means any enclosure or structure specifically designed, constructed, and used—
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> (A) for housing, raising, and feeding a particular type of livestock and their produce, and
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> (B) for housing the equipment (including any replacements) necessary for the housing, raising, and feeding referred to in subparagraph (A).

In their petition to this Court, petitioners assert that both the kennel facility and the horse barn are single purpose livestock structures within the meaning of section 48(p)(2). Pursuant to the Court's leave, petitioners also amended their petition to include their claim that the kennel facility is a structure which is essentially an item of machinery or equipment within the meaning of section 1.48–1(e)(1), Income Tax Regs., and therefore section 38 property. At trial and on brief, petitioners concede that the front part of the kennel facility (the front structure) is a building and therefore does not qualify as section 38 property unless the entire kennel facility is a single purpose livestock structure. They contend, however, that if the kennel facility is not a single purpose livestock structure, the back part of the facility (the boarding structure) is nevertheless section 38 property because it is a structure which is essentially an item of machinery or equipment within the meaning of section 1.48–1(e)(1), Income Tax Regs.[8] Petitioners seem to assume that the "machinery or equipment" argument will automatically bring them within section 48(a)(1)(A)—tangible personal property—and thus qualify the boarding structure as section 38 property. We note that petitioners do not argue, and properly so, that the kennel facility or any portion thereof qualifies as "other tangible property" within the meaning of section 48(a)(1)(B). That provision is clearly tied to specific types of activities that are not involved in this case. We will discuss each contention in turn.

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[8] At trial, respondent objected to petitioner's testimony regarding a cost allocation among various parts of the kennel facility because he thought that the issue of whether only a part of the kennel facility qualifies as sec. 38 property was not an issue properly before the Court. See note 5 and accompanying text, *supra*. The Court allowed such testimony under Rule 41(b)(2). Petitioners' amendment to the petition was sufficient to raise the issue. Moreover, because of our resolution of this issue, our consideration of it has not prejudiced respondent. See Rule 41(b)(2).

I. The Kennel Facility as a Single Purpose Livestock Structure

Section 48(p)(2) defines a single purpose livestock structure as an enclosure or structure specifically designed, constructed, and used for housing, raising, and feeding a particular type of livestock and their produce and for housing any related equipment. Petitioners argue that the kennel facility is a single purpose livestock structure within the meaning of section 48(p)(2) because it was specifically designed, constructed, and used to temporarily board household pets. They say that temporary boarding constitutes "housing" within the meaning of section 48(p)(2)(A). Petitioners support this argument by contending that under section 1.48–10(b)(2)(i), Income Tax Regs.,[9] a single purpose livestock structure may be used for any one of the three activities listed in section 48(p)(2)(A) (i.e., housing, raising, *or* feeding). Petitioners also contend that household pets are livestock for purposes of section 48(p).

Respondent disagrees on both counts. He argues that household pets are not livestock. He further argues that temporarily boarding household pets does not constitute "housing, raising, and feeding a particular type of livestock" within the meaning of section 48(p)(2) and section 1.48–10(b)(2)(i), Income Tax Regs. Respondent interprets the "housing, raising, and feeding a particular type of livestock" language of the statute and regulation as requiring that a structure be used in agricultural or food production before it can qualify as a single purpose livestock structure. Petitioners suggest that such an interpretation directly conflicts with the legislative history of section 48(p).

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[9] In pertinent part, sec. 1.48–10(b)(2), Income Tax Regs., provides as follows:

> (2) *Permissible purposes.* The following are the only permissible purposes for a single purpose agricultural structure:
>
> (i) Housing, raising, and feeding a particular type of livestock and, at the taxpayer's option, its produce. The term "housing, raising, and feeding" includes the full range of livestock breeding and raising activities, including ancillary post-production activities (as defined in paragraph (f) of this section). *Thus, for example, use of a structure for breeding livestock, or for producing eggs or livestock, is permitted.* * * * [Emphasis added.]

Petitioners actually cited to the Court sec. 1.48–10(*d*)(2)(i), Income Tax Regs. for this proposition, but we assume they intended section 1.48–10(*b*)(2)(i). Sec. 1.48–10(d), Income Tax Regs., as finally adopted, T.D. 7900, 1983–2 C.B. 18, 22, and as originally proposed, LR-88-79, 46 Fed. Reg. 7397 (Jan. 23, 1981), 1981–1 C.B. 746, 749, defines the phrase "specifically designed and constructed." It has no subsections.

Petitioners acknowledge that the only cases addressing the qualification of a structure as a single purpose livestock structure have involved structures used in agricultural or food production. See *Lesher v. Commissioner*, 73 T.C. 340 (1979), affd. per curiam 638 F. 2d 64 (8th Cir. 1981) (cattle feeding structure); *Berg v. Commissioner*, T.C. Memo. 1979–58 (hog farrowing structure). Moreover, a leading commentator describes qualifying structures as those used in agricultural or food production. See 5 J. Mertens, Law of Federal Income Taxation, secs. 32A.14 and 32A.19h, at 113, 154 (1980 rev.). For a detailed analysis of the legislative history of sections 48(a)(1)(D) and 48(p), see Solomon and Luchs, " . . . And This Little Piggy Went to Congress: The Revenue Act of 1978 and the Investment Tax Credit for Single-Purpose Agricultural and Horticultural Structures," 33 Southwestern L. J. 663 (1979–1980). Petitioners do not, and we think cannot, point to any part of the legislative history of section 48(p) that supports their position.

As originally adopted by the House of Representatives, H.R. 13511, 95th Cong., 2d Sess. (Aug. 10, 1978), which became the Revenue Act of 1978, *supra*, contained no provision dealing with investment credit for single purpose livestock structures. H. Rept. 95–1800 (1978), 1978–3 C.B. (Vol. 1) 521, 560.[10] The Senate amended H.R. 13511, *supra*, to make specifically eligible for the investment credit those structures, including poultry and livestock structures and greenhouses, which are specifically designed, constructed, and used for single purpose food and plant production.[11] H. Rept. 95–1800, *supra*, 1978–3 C.B. (Vol. 1) at 561. Prior to the conference agreement on H.R. 13511, the House of Representatives passed H.R. 12846, 95th Cong., 2d Sess. (Oct. 13, 1978), which provided that a poultry or hog structure was to qualify for the investment credit if, inter alia, it was specifically designed and constructed for the housing, raising, and feeding of poultry or hogs, and their produce.[12] H. Rept. 95–1761, to accompany H.R. 12846, 95th Cong., 2d Sess. 3–5 (1978), made it clear that the focus of H.R. 12846, like the Senate amendment to H.R. 13511, was structures used in agricultural and food production activities:

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[10] Although numbered as a House report, this report was actually submitted by the Committee of the Conference.

> The bill clarifies present law by providing that structures and enclosures are specifically eligible for the investment credit where they are specifically designed, constructed and used for the *husbandry* of hogs and chickens or for the commercial *production* of plants and plant produce.
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> * * * * * * *
>
> The full range of swine and poultry *breeding, raising and production activities* are intended to be included so that special purpose structures will qualify for credit if used, for example, to *breed* chickens or hogs, or to *produce* feeder pigs, broiler chickens, or eggs. * * *
>
> [Emphasis added.]

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[11] The specific language of the Senate amendment was as follows:

SEC. 314. INVESTMENT CREDIT FOR SINGLE PURPOSE AGRICULTURAL STRUCTURES.
(a) IN GENERAL.—Section 48(a)(1) (relating to section 38 property), is amended by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", or", and by adding the following after subparagraph (C) thereof:
"(D) a structure specifically designed, constructed, and utilized for *single purpose food and plant production*, including but not limited to production of eggs, poultry, and livestock."
[H.R. 13511, 95th Cong., 2d Sess. 304–305 (Oct. 10, 1978). Emphasis added.]

[12] The pertinent language of H.R. 12846 was as follows:

That (a) paragraph (1) of section 48(a) of the Internal Revenue Code of 1954 (defining section 38 property) is amended by striking out the period at the end of subparagraph (C) and inserting in lieu thereof ", or" and by inserting after subparagraph (C) the following new subparagraph:
"(D) single purpose agricultural or horticultural structures."
(b) Section 48 of such Code is amended by redesignating subsection (1) as subsection (m) and by inserting after subsection (k) the following new subsection:
"(i) [sic] Single Purpose Agricultural or Horticultural Structure Defined.—For purposes of this section—
"(1) In General.—The term 'single purpose agricultural or horticultural structure' means—
(A) a single purpose poultry or hog structure, and
(B) a single purpose greenhouse.
"(2) Single Purpose Poultry or Hog Structure.—The term 'single purpose poultry or hog structure' means any enclosure or structure specifically designed, constructed, and used—
"(A) for housing, raising, and feeding poultry or hogs and their produce, and
"(B) for housing the equipment (including any replacements) necessary for the housing, raising, and feeding referred to in subparagraph (A)."

The conference agreement modified the Senate amendment to specifically extend the investment credit to special purpose structures used for livestock and horticultural products and to adopt the general conditions and requirements of H.R. 12846, *supra*. H. Rept. 95–1800, *supra*, 1978–3 C.B. (Vol. 1) at 561.

Petitioners argue that the omission of the specific "food and plant production" language of the Senate amendment from the final version of H.R. 13511 should be a significant factor in our interpretation of section 48(p)(2), citing *Carey v. Donohue*, 240 U.S. 430 (1916), and *Penna. R.R. Co. v. International Coal Co.*, 230 U.S. 184 (1913). Petitioners further contend that to give this legislative history effect, we must include within the statutory phrase "housing, raising, and feeding a particular type of livestock" activities such as the temporary boarding of household pets. We disagree.

The legislative explanations of section 48(p)(2) are replete with references to agricultural and food production. The Conference report on what became the Revenue Act of 1978, H. Rept. 95–1800 (1978), 1978–3 C.B. (Vol. 1) 521, 561, contains language similar to the language from H. Rept. 95–1761, to accompany H.R. 12846 (1978), quoted in the text, *supra*:

> The full range of livestock *breeding, raising and production activities* is intended to be included so that special purpose structures will qualify for credit if used, for example, to *breed* chickens or hogs, to *produce* milk from dairy cattle, or to *produce* feeder cattle or pigs, broiler chickens, or eggs. * * * [Emphasis added.]

The Staff of the Joint Committee on Taxation stated as follows:

> [Sections 48(a)(1)(D) and 48(p) make] structures or enclosures used for single purpose livestock or plant *production* specifically eligible for the investment tax credit. To be eligible for the credit under the Act, the structure must be both specially designed and used solely for the *production* of poultry, eggs, livestock, or plants * * * [Staff of Joint Comm. on Taxation, 96th Cong., 1st Sess., General Explanation of the Revenue Act of 1978, at 152 (J. Comm. Print 1979). Fn. ref. omitted; emphasis added.][13]

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[13] See also Staff of Joint Comm. on Taxation, 95th Cong., 2nd Sess., Section-By-Section Summary of the Revenue Act of 1978, Energy Tax Act of 1978, Foreign Earned Income Act of 1978, Fringe Benefits Act; Prepared for the Use of the Committee on Ways and Means U.S. House of Representatives and the Committee on Finance U.S. Senate at 31 (J. Comm. Print 1978) ("The Act clarifies prior law by specifically providing that single purpose structures used to *produce* livestock, poultry, eggs, plants, and plant products are eligible for the investment credit." (Emphasis added.)); Staff of Joint Comm. on Taxation, 95th Cong., 2d Sess., Summary of Principal

These references contain language almost identical to that found in the report accompanying the Senate version of H.R. 13511, *supra*, which contained the "food or plant production" language.[14]

More importantly, the reason Congress enacted sections 48(a)(1)(D) and 48(p) clearly demonstrates that it did not intend to include structures like petitioners' kennel facility within the definition of a single purpose livestock structure. Since it was first added to the Code in 1962,[15] section 48(a) has always defined section 38 property to include, inter alia, tangible personal property and other tangible property (other than buildings and their structural components) but only if such other tangible property is an integral part of manufacturing, production, or other activities set forth in section 48(a)(1)(B). See secs. 48(a)(1)(A) and 48(a)(1)(B). When Congress reinstated the investment credit in 1971,[16] the Senate Finance Committee discussed in its report the types of structures that would qualify for the investment credit as other tangible property used in manufacturing, production, or other activities described in section 48(a)(1)(B). S. Rept. 92–437 (1971), 1972–1 C.B. 559, 575. The committee stated that one example of a qualifying structure was a structure used as a unitary hog-raising system. S. Rept. 92–437, *supra*, 1972–1 C.B. at 575. See Staff of Joint Comm. on Taxation, 96th Cong., 1st Sess., General Explanation of the Revenue Act of 1978, at 151 (Comm. Print 1979) (the General Explanation). Thus, the committee considered such structures to be used in production activities, farming having long been considered a production activity.[17] Despite the Senate Finance Committee's expression

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Provisions of H.R. 13511, The Revenue Act of 1978; H.R. 5263, The Energy Tax Act of 1978; H.R. 9251, The Foreign Earned Income Act of 1978; H.R. 12841 (Pub. Law 95–427), Relating to Tax Treatment of Fringe Benefits at 15 (J. Comm. Print 1978) ("The application of present law is clarified for special purpose structures used to *produce* livestock (including poultry), plants, and their produce, so that these structures are specifically eligible for the credit." (Emphasis added.))

[14] S. Rept. 95-1263 (1978), 1978–3 C.B. (Vol. 1) 315, 414 ("To be eligible for the credit under the bill, the structure must be both specially designed and used solely for the *production* of poultry, eggs, livestock, or plants." (Emphasis added.))

[15] Sec. 2(b) of the Revenue Act of 1962, Pub. L. 87-834, 76 Stat. 960, 963–970, 1962–3 C.B. 111, 114–120.

[16] The investment credit was, with certain exceptions, terminated by sec. 703(a) of the Tax Reform Act of 1969, Pub. L. 91–172, 83 Stat. 487, 660–666, 1969–3 C.B. 10, 111–114. The investment credit was reinstated by sec. 101 of the Revenue Act of 1971, Pub. L. 92-178, 85 Stat. 497, 498–499, 1972–1 C.B. 443, 443–444, for property constructed or acquired after Aug. 15, 1971.

[17] Although the statement emphasizes that such structures were not buildings and thereby ineligible for the investment credit, it also clearly indicates that the committee considered such

of intent, the Internal Revenue Service continued a case-by-case approach in determining whether single purpose farm structures qualified for the investment credit. H. Rept. 95-1761, *supra* at 4-5; General Explanation, *supra* at 151. As the Senate report on H.R. 13511 (the Revenue Act of 1978), S. Rept. 95-1263 (1978), 1978-3 C.B. (Vol. 1) 315, 414, stated:

> When the investment tax credit was restored in 1971 it was the intention of the committee, as expressed in its report on the Revenue Act of 1971, to make it clear that the credit as restored was to apply to special purpose agricultural structures. Despite this expression of intent, the Internal Revenue Service has denied the credit to special purpose agricultural structures and enclosures used for raising poultry, livestock, horticultural products or for producing eggs. Taxpayers' litigation to establish their right to these credits is both expensive and troublesome, particularly in cases involving small farmers with limited amounts of eligible property. As a result of this continuing controversy, the committee has decided to specifically provide that these agricultural structures are eligible for the investment credit.

The House report on H.R. 12846 (which was subsumed into the Revenue Act of 1978, and became sections 48(a)(1)(D) and 48(p)), H. Rept. 95-1761, *supra* at 3-5, and the General Explanation *supra* at 151-152, cite this background as the reason sections 48(a)(1)(D) and 48(p) were enacted. H. Rept. 95-1761, *supra* at 5, further states as follows:

> This bill *clarifies present law* to specifically provide that certain greenhouses and poultry or hog structures and enclosures are eligible for the investment tax credit. *Because these provisions are regarded as clarifying amendments*, they are made applicable to taxable years ending after August 15, 1971, the date when the investment credit was restored. [Emphasis added.]

Thus, in 1971 Congress thought that single purpose agricultural structures qualified for the investment credit under section 48(a)(1)(B) as other tangible property used in production activities. When the Internal Revenue Service failed to so treat these structures, Congress enacted sections 48(a)(1)(D) and 48(p) to eliminate any doubt and to mandate such treatment. This legislative history makes it crystal clear that the term "single purpose livestock structure" as defined in

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structures to be used in production activities. Farming has long been considered a production activity for sec. 48(a)(1)(B) purposes. See Rev. Rul. 66-89, 1966-1 C.B. 7.

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section 48(p)(2) is not intended to encompass structures such as petitioners' kennel facility, which is used for the temporary boarding of household pets and is not a structure used in agricultural or food production. Such activity does not constitute "housing, raising, and feeding a particular type of livestock" within the meaning of section 48(p)(2)(A). Consequently, the kennel facility is not a single purpose livestock structure within the meaning of section 48(p)(2).[16]

II. The Boarding Structure as an Item of Machinery or Equipment

Petitioners argue that even if the entire kennel facility is not a single purpose livestock structure, the rear portion thereof (the boarding structure) nevertheless qualifies as section 38 property because it is essentially an item of machinery or equipment within the meaning of sec. 1.48–1(e)(1), Income Tax Regs. Petitioners contend that because of its design, function, and use, the boarding structure operates as an apparatus necessary for the housing, care, and maintenance of the boarded animals and is therefore essentially an item of machinery or equipment. Because it is machinery or equipment, petitioners continue, the boarding structure is not a building for purposes of section 48, and therefore, it must be tangible personal property within the meaning of section 48(a)(1)(A).

In determining whether the boarding structure is section 38 property, we decline to focus on a clause in the regulations and back our way into the Code as petitioners would have us do. Rather, we think the proper order of analysis is to first carefully consider the statutory language, and then to look to the regulations for further guidance.

Sections 48(a)(1)(A) and 48(a)(1)(B) include in the definition of section 38 property both tangible personal property and other tangible property (not including a building and its structural components) but only if such other tangible property is used in activities described in section 48(a)(1)(B). As noted above, petitioners do not argue that the boarding structure is

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[16] Although we need not reach the issue, we agree with respondent's other argument that household pets are not livestock within the meaning of sec. 48(p). See secs. 1.48–10(b)(3) and 1.48–1(l)(1), Income Tax Regs.

"other tangible property" used in one of the activities described in section 48(a)(1)(B). The term tangible personal property is not defined by the statute. However, section 1.48–1(c), Income Tax Regs.,[19] defines tangible personal property as "any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures)." See *Standard Oil Co. (Indiana) v. Commissioner*, 77 T.C. 349, 405 (1981). Local law is not determinative of whether property is tangible or personal. Sec. 1.48–1(c), Income Tax Regs. The phrase tangible personal property is to be interpreted broadly. *Consolidated Freightways, Inc. v. Commissioner*, 74 T.C. 768, 797 (1980), revd. on another issue 708 F.2d 1385 (9th Cir. 1983); *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664, 671 (1975). Nevertheless, the regulation clearly states that tangible personal property does not include land and improvements thereto, such as buildings or other inherently permanent structures.

Despite this clear language, petitioners point to section 1.48–1(e)(1), Income Tax Regs.,[20] which defines the term building for purposes of section 48 and the regulations thereunder. The regulation provides, inter alia, that the term building "does not include (i) a structure which is essentially an item of machinery or equipment." However, even if the boarding structure is not a building because it is essentially an item of machinery and equipment, that does not necessarily mean it is tangible personal property. Other inherently permanent structures as well as buildings are excluded from the definition of tangible personal property. See sec. 1.48–1(c), Income Tax Regs.

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[19] Sec. 1.48–1(c), Income Tax Regs., provides as follows:

(c) *Definition of tangible personal property.* If property is tangible personal property it may qualify as section 38 property irrespective of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connection with such activity) specified in paragraph (a) of this section. Local law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal". Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building, constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

[20] Sec. 1.48–1(e)(1), Income Tax Regs., provides as follows:

(e) *Definition of building and structural components.* (1) Buildings and structural components thereof do not qualify as section 38 property. The term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office

Neither the Code nor the regulations define the phrase inherently permanent structure. However, in *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. at 672–673, this Court enumerated the following six inquiries that we consider relevant in distinguishing between tangible personal property and inherently permanent structures:[21]

(1) Is the property capable of being moved, and has it in fact been moved?

(2) Is the property designed or constructed to remain permanently in place?

(3) Are there circumstances which tend to show the expected or intended length of affixation, i.e., are there circumstances which show that the property may or will have to be moved?

(4) How substantial a job is removal of the property, and how time-consuming is it? Is it "readily movable"?

(5) How much damage will the property sustain upon its removal?

(6)What is the manner of affixation of the property to the land?

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buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term does not include (i) a structure which is essentially an item of machinery or equipment, or (ii) a structure which houses property used as an integral part of an activity specified in section 48(a)(1)(B)(i) if the use of the structure is so closely related to the use of such property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. Factors which indicate that a structure is closely related to the use of the property it houses include the fact that the structure is specifically designed to provide for the stress and other demands of such property and the fact that the structure could not be economically used for other purposes. Thus, the term "building" does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples.

[21] See also *Southland Corp. v. United States*, 222 Ct. Cl. 22, 611 F.2d 348 (1979); *Standard Oil Co. (Indiana) v. Commissioner*, 77 T.C. 349, 406–409 (1981); *Kimmelman v. Commissioner*, 72 T.C. 294, 308 (1979).

The record is entirely devoid of any facts that, when considered in answering these six inquiries, suggest that the boarding structure is anything other than an inherently permanent structure. Moreover, at trial petitioners orally stipulated that the entire kennel facility, including the boarding structure, (1) is a permanent structure, (2) is fixed to the ground, (3) has a foundation, and (4) could not be moved without destruction of the property. Thus, even if the boarding structure is not a building, it is an inherently permanent structure and therefore is not tangible personal property within the meaning of section 48(a)(1)(A). Sec 1.48–1(c), Income Tax Regs.

Additionally, we think it clear that the boarding structure is not essentially an item of machinery or equipment and that it is therefore a building within the meaning of section 1.48–1(e)(1), Income Tax Regs. Although components of the boarding structure are specifically designed to aid the sanitary maintenance of boarded animals, the structure is not a mere processing chamber. See *Sunnyside Nurseries v. Commissioner*, 59 T.C. 113, 121 (1972). The boarding structure does not in itself feed, care for, or otherwise maintain the animals boarded therein. Rather, the boarding structure does no more than provide the setting in which the petitioners feed, care for, and otherwise maintain the boarded animals. *Consolidated Freightways, Inc. v. Commissioner*, 74 T.C. at 796. See *Yellow Freight System, Inc. v. United States*, 538 F.2d 790, 797 note 11 (8th Cir. 1976); *Endres Floral Co. v. United States*, 450 F. Supp. 16, 24 (N.D. Ohio 1977). Paraphrasing what we said in *Consolidated Freightways, Inc. v. Commissioner*, 74 T.C. at 796, "[the boarding structure is] no more an item of machinery to [feed, care for, and otherwise maintain the boarded animals] than the building in which the Tax Court is housed is an item of equipment to produce our opinions."[22] Thus, the boarding structure is a building within the meaning of section 1.48-1(e)(1), and therefore is not section 38 property.[23]

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[22] The present case is factually distinguishable from those cases where the building-like structures functioned not as the setting for human activity but functioned as part of the manufacturing or production process itself. See *Thirup v. Commissioner*, 508 F.2d 915 (9th Cir. 1974), revg. 59 T.C. 122 (1972) (greenhouses as essentially equipment or part of the manufacturing or production process of growing plants); *Brown-Forman Distillers Corp. v. United States*, 499 F.2d 1263 (Ct. Cl. 1974) (whiskey maturation structures served essentially as an "oven" to age the whiskey); *Satrum v. Commissioner*, 62 T.C. 413 (1974) (specifically designed walls, roof, and floors of "henhouse" served as integral part of egg-producing facility); *Central Citrus Co. v. Commissioner*, 58 T.C. 365 (1972) (the "sweet room" served to ripen and condition the fruit); *Catron v. Commissioner*, 50 T.C. 306 (1968) (facility to provide cold storage for apples), *Brown & Williamson*

III. *The Horse Barn as a Single Purpose Livestock Structure*

Petitioners argue that their horse barn qualifies as section 38 property because it is a single purpose livestock structure within the meaning of section 48(p)(2). Respondent contends that the horse barn does not so qualify because it is a general purpose structure that could economically be used for a purpose other than the purpose for which it was specifically designed and constructed. This, respondent continues, precludes the horse barn from satisfying the statutory requirement that a qualifying structure be specifically designed and constructed for a qualifying purpose. See sec. 48(p)(2). Respondent also argues that horses are not livestock as the term is used in section 48(p)(2)(A). We agree with both of respondent's arguments.

Section 48(p)(2) defines a single purpose livestock structure as "any enclosure or structure specifically designed, constructed, and used" for described purposes. Section 1.48-10(d), Income Tax Regs., provides that "A structure is specifically designed and constructed if it is not economic to design and construct the structure for the intended qualifying purpose and then use the structure for a different purpose."

Petitioners' horse barn is a "Lester" general purpose design building. When petitioners constructed it, they varied the design by increasing its height, adding an overhang to one end of the building, and putting in windows. During 1976, the interior of the barn was one big open space. In subsequent

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Tobacco Corp. v. United States, 369 F. Supp. 1283 (W.D. Ky. 1973), affd. per curiam 491 F.2d 1258 (6th Cir. 1974) (tobacco sheds functioned to store and age the tobacco).

[23] Having held that the boarding structure does not by itself qualify as sec. 38 property, we need not determine the proper allocation of petitioners' cost for the kennel facility between the front structure and the boarding structure. See note 5 and accompanying text, *supra*.

Mr. McKenzie testified as to the portion of the kennel facility's cost he would allocate to the fencing throughout and surrounding the boarding structure. However, petitioners never argued that such fencing by itself qualifies as sec. 38 property. In any event, fencing is specifically excluded from the definition of tangible personal property. Sec. 1.48-1(c), Income Tax Regs.; *Consolidated Freightways, Inc. v. Commissioner*, 74 T.C. 768, 799 (1980), revd. on another issue 708 F.2d 1385 (9th Cir. 1983). Petitioners' fencing is not other tangible property used in one of the activities described in sec. 48(a)(1)(B) and therefore cannot qualify as sec. 38 property under that section. Thus, the fencing is not sec. 38 property, and we need not determine the portion of the kennel facility's total cost properly allocable to it.

years, petitioners installed two additional doors, put in stall and hay storage space, and made other improvements to the inside of the barn. They intend to make more improvements as they can afford them. Nonetheless, petitioners acknowledged on brief that the horse barn is a general purpose structure that could economically be used for purposes other than the purpose for which it was constructed. This acknowledgement is completely supported by the testimony at trial. Consequently, the horse barn was not specifically designed and constructed within the meaning of section 48(p)(2). Sec. 1.48-10(d), Income Tax Regs. See S. Rept. 95-1263 (1978), 1978-3 C.B. (Vol. 1) 315, 415, which stated that:

> The amendment [the forerunner of sections 48(a)(1)(D) and 48(p), see note 11 and accompanying text, *supra*] is not intended to apply to general purpose agricultural structures such as barns and other farm structures which can be adopted to a variety of uses.

Thus, the barn is not a single purpose livestock structure and therefore, is not section 38 property. Secs. 48(p)(2) and 48(a)(1)(D).

We also agree with respondent that horses are not livestock within the meaning of section 48(p)(2)(A). The regulations specifically exclude horses from the definition of livestock. Section 1.48-10(b)(3), Income Tax Regs., provides as follows:

> (3) *Livestock; particular type of livestock—(i) Livestock.* Livestock qualifying as "section 38 property" under sec. 1.48-1(l) constitutes livestock for purposes of this section. Thus, for example, horses are not livestock for purposes of this section since they do not qualify as "section 38 property" under sec. 1.48-1(l). Under section 48(p)(6) poultry constitutes livestock for purposes of section 48(a)(l)(D). The term "livestock" includes the offspring of livestock. "Livestock" is distinguished from the produce of livestock, such as milk and eggs held for sale. For purposes of this section, eggs held for hatching and newborn livestock are considered livestock. * * *

Section 1.48-1(l)(1), Income Tax Regs., also provides that:

> (l) *Livestock—(1) In general.* The term "section 38 property" does not include horses but such term does include all other livestock that is property described in section 50. The term "livestock" includes cattle, hogs, sheep, goats, and mink and other fur-bearing animals.

These are legislative regulations promulgated pursuant to specific statutory authority (sec. 38(b)), and as such are to be accorded great weight. *Bingler v. Johnson*, 394 U.S. 741, 749–751 (1969); *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496 (1948). We do not think these regulations are inconsistent with or go beyond the statute. We think the regulations implement the statute in a reasonable manner.

Petitioners argue that the mere fact that horses themselves do not qualify as section 38 property should not be determinative. However, petitioners have not suggested, and the Court cannot conceive of, any reason why the Congress would grant an investment tax credit for structures for housing, raising, or feeding horses if the animals themselves do not qualify for such a credit. We note that the statute itself expressly included poultry in the term "livestock." Sec. 48(p)(6). Petitioners have not pointed to anything in the statute or its legislative history, and the Court has not found anything, to support petitioners' argument that their Arabian horses qualify as livestock under section 48(p)(2).[24] We conclude that the regulations, at least as applied to the facts of this case, are valid.

To reflect the foregoing,[25]

Decision will be entered for the respondent.

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[24] During consideration of H.R. 13511, the Senate proposed an amendment, effective after Dec. 31, 1978, to extend the investment credit to horses used for working or breeding purposes (but not horses used for sporting purposes such as race or show horses). The Conference agreement omitted this Senate amendment. H. Rept. 95–1800, 1978–3 C.B. (Vol. 1) 315, 562–563.

[25] In their petition and brief, petitioners requested that we award them attorneys' fees. The petition herein was filed on Jan. 8, 1982. Thus, this Court has no jurisdiction to award such fees in this case. *McQuiston v. Commissioner*, 78 T.C. 807 (1982), affd. without published opinion 711 F.2d 1064 (9th Cir. 1983). See also *Key Buick Co. v. Commissioner*, 613 F.2d 1306 (5th Cir. 1980), affg. 68 T.C. 178 (1977). Under sec. 7430, added to the Code by sec. 292(a) of the Tax Equity and Fiscal Responsibility Act of 1982, 96 Stat. 324, 572, 1982–2 C.B. 462, 546–547, we have authority to award reasonable litigation costs to a "prevailing party" in a proceeding commenced in this Court after Feb. 28, 1983. See also Rules 230–233. Moreover, Rule 34, in pertinent part, provides that "A claim for reasonable litigation costs *shall not be included in the petition* in a deficiency or liability action." (Emphasis added.) In general, under Rule 231 the time for making such claims is *after* the substantive issues have been resolved.

Barbados #6 Ltd., a Partnership, Bajan Services, Inc., Tax Matters Partner, Petitioner v. Commissioner of Internal Revenue, Respondent

Barbados #5 Ltd., a Partnership, Bajan Services, Inc., Tax Matters Partner, Petitioner v. Commissioner of Internal Revenue, Respondent[1]

Docket Nos. 33764–84, 33878–84. Filed December 10, 1985.

Held, Tax Court has jurisdiction where tax matters partner, which also satisfied all requirements as notice partner, timely filed petition as notice partner within 60 days after 90-day period given to tax matters partner, pursuant to sec. 6226(b), I.R.C. of 1954, as amended.

Edward G. Lavery and *Larry K. Hercules*, for the petitioners.

R. Alan Lockyear and *Henry Schneiderman*, for the respondent.

OPINION

Cantrel, *Special Trial Judge*: These cases are before the Court on respondent's motion to dismiss for lack of jurisdiction filed in each case on April 1, 1985; and on petitioner's motion filed in each case for leave to file amended petition and to change caption, filed on April 25, 1985. Petitioner also filed a response in each case to respondent's motion on April 25, 1985. These cases were called from the calendar at the motions session of the Court at Washington, D.C., on June 5, 1985, when counsel for both parties appeared and presented argument on all the motions in both cases. At the conclusion of the hearing the Court took the motions under advisement.[2]

On June 18, 1984, respondent issued notices of final partnership administrative adjustment (sometimes referred to as FPAA) for Barbados #5 Ltd., and Barbados #6 Ltd., to Mr. Wally Jensen, president of Bajan Services, Inc., in Salt Lake

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[1] These cases are combined solely for purposes of this opinion. Although this opinion relates to two partnerships, we will refer to Bajan Services, Inc., in the singular as the petitioner. Our reading of sec. 6226(a), (b), (c) and (g), Internal Revenue Code of 1954 as amended, reveals that the tax matters partner or notice partner is in fact the petitioner in a case under subch. C of ch. 63, 1954 as amended. Thus Bajan Services, Inc., is the petitioner in each case. See also Tax Court Rules of Practice and Procedure, Rules 240(d) and 241(c).

[2] These cases were assigned pursuant to section 7456(d)(4), Internal Revenue Code of 1954 as amended, and Rules 180 and 181, Tax Court Rules of Practice and Procedure.

City, Utah pursuant to section 6223(a)(2).[3] Subsequently, on June 25, 1984, identical notices of final partnership administrative adjustment for each of the limited partnerships were issued to Bajan Services, Inc., in Salt Lake City. In each of the two sets of notices the following notation appeared in the heading information: "Date FPAA Mailed to Tax Matters Partner: June 18, 1984." The two sets of notices were respectively date-stamped June 18, 1984, and June 25, 1984, and contained the following language:

> We have determined that there are adjustments to the partnership as shown on the attached schedule(s). This letter is the Notice of Final Partnership Administrative Adjustments (FPAA) sent to you as required by law.
>
> If you are the Tax Matters Partner and want to contest these adjustments in court, you have 90 days from the mailing date of this letter to file a petition for readjustment of the partnership items with
>
> 1. The United States Tax Court;
> 2. The District Court of the United States for the district in which the partnership's principal place of business is located; or
> 3. The United States Claim[s] Court.
>
> If the Tax Matters Partner has not filed a petition by the 90th day from the date the FPAA was mailed, any other partner entitled to receive this notice under section 6223 of the Internal Revenue Code or any group of partners who together have an interest of 5 percent or more in the profits of the partnership may petition one of the above courts after the 90th day but on or before the 150th day from the mailing date of the FPAA to the Tax Matters Partner as shown above.

In the case of Barbados #6 Ltd., respondent disallowed a partnership interest expense in the amount of $1,832,000 and increased the partnership's income by $10,000 for the tax year ending December 31, 1982.[4] In the case of Barbados #5 Ltd., respondent disallowed a partnership interest expense of

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[3] All section references are to the Internal Revenue Code of 1954 as amended; and all Rule references are to the Tax Court Rules of Practice and Procedure. To date, temporary or final regulations have not been promulgated by the Secretary of the Treasury pertaining to the tax treatment of partnership items for income tax purposes.

[4] The new partnership provisions of subch. C of ch. 63, I.R.C. 1954 as amended, are generally effective for partnership taxable years beginning after Sept. 3, 1982. For partnership taxable years beginning before and ending after Sept. 3, 1982, the new partnership provisions apply only if the partnership, with the consent of each partner, requests to have the new provisions apply and the Secretary of the Treasury consents to such application. The partnerships in these cases, Barbados #5 Ltd. and Barbados #6 Ltd., commenced business on Nov. 18, 1982, and Nov. 19, 1982, respectively. Because the partnerships' taxable years begin and end after Sept. 3, 1982, the new provisions apply irrespective of a request and consent. See generally Tax Equity and Fiscal Responsibility Act of 1982, sec. 407, 96 Stat. 670; cf. Rev. Proc. 83-8, 1983-1 C.B. 639.

$5,335,000 and increased the partnership's income by $48,500 for the tax year ending December 31, 1982.[5]

Petitioner mailed its petition in each case to the Tax Court on September 21, 1984, which was 95 days after respondent issued the June 18 FPAA and 88 days after he issued the June 25 FPAA. Petitioner attached only the June 25, 1984, notice of FPAA to each petition.

Respondent filed the motions to dismiss that we consider herein challenging the Court's jurisdiction over these cases on the theory that petitioner, as tax matters partner, failed to file a timely petition in each case. Respondent asserts that the District Director of the Internal Revenue Service, Salt Lake City, issued the FPAA notice to petitioner, as the tax matters partner on June 18, 1984, and that petitioner filed a petition on behalf of each partnership as the tax matters partner. Thus, respondent alleges, to be timely filed the petitions must have been filed on or before September 17, 1984, the 90th day, as extended,[6] after the FPAA notice was mailed pursuant to section 6226(a).

Subsequently, petitioner filed its motion for leave to file an amended petition and to change the caption in each case to include individual limited partners, citing as one reason the new Court rules regarding partnership proceedings, title XXIV, Rules of Practice and Procedure, 82 T.C. 1076, effective January 1, 1984.[7] In opposing respondent's motions to dismiss, petitioner argues that the June 25 notice of FPAA superseded the June 18 notice, that the petitions were filed on behalf of all the partners in the partnerships, that filing the petitions tolled the running of the 60-day period provided in section 6226(b)(1) so that any notice partner may now enter as a named petitioner, and, finally, that petitioner could file the petitions any time within the 150-day period because it is a notice partner as well as the tax matters partner in each partnership.

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[5] In all material respects other than the amounts disallowed as expenses and amounts added to partnership income, the notices of final partnership administrative adjustment sent to petitioner with respect to each partnership were identical. We will therefore, hereinafter refer to them singly as "the notice of FPAA" or the "FPAA," differentiating them only by date.

[6] The 90th day was Sunday, Sept. 16, 1984. Thus, the filing period was extended to Monday, Sept. 17, 1984. See sec. 7503.

[7] Both petitions were filed prior to Oct. 15, 1984, the date on which the Court promulgated its partnership rules. These are the first cases before the Court involving these new rules.

For the reasons set forth hereinbelow, we hold that petitioner is both a tax matters partner and a notice partner as defined in section 6231(a)(7) and (8), respectively, and thus is qualified to file a petition in the Tax Court within the 90-day period provided in section 6226(a) or within the 60-day period provided in section 6226(b).

In the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97–248, 96 Stat. 324, Congress introduced a system whereby the tax treatment of items of partnership income, loss, deductions, and credits would be determined at the partnership level in a unified partnership proceeding at both the administrative and judicial levels. Under this system, each partner generally must treat a partnership item in a manner consistent with the treatment of that item on the partnership return. Sec. 6222(a). In addition, this Court has jurisdiction to determine the partnership items and the proper allocation of such items among the partners for the partnership taxable year to which the notice of FPAA relates (sec. 6226(f));[8] and all the partners in a partnership are bound by such determination.

To commence judicial review of a FPAA, a timely petition for readjustment of the partnership items must be filed pursuant to section 6226.[9] With 90 days after the Internal Revenue

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[8] As in a deficiency case, a proceeding in the Tax Court provides a prepayment forum, while a petition may be filed in a Federal District Court or the Claims Court only if the partner filing the petition pays the amount of his allotted share of the increase in tax liability determined in the FPAA.

[9] Sec. 6226(a) and (b) provides:

SEC. 6226(a). PETITION BY TAX MATTERS PARTNER.—Within 90 days after the day on which a notice of a final partnership administrative adjustment is mailed to the tax matters partner, the tax matters partner may file a petition for readjustment of the partnership items for such taxable year with—

(1) the Tax Court,

(2) the district court of the United States for the district in which the partnership's principal place of business is located, or

(3) the Claims Court.

(b) PETITION BY PARTNER OTHER THAN TAX MATTERS PARTNER.—

(1) IN GENERAL.—If the tax matters partner does not file a readjustment petition under subsection (a) with respect to any final partnership administrative adjustment, any notice partner (and any 5-percent group) may, within 60 days after the close of the 90-day period set forth in subsection (a), file a petition for a readjustment of the partnership items for the taxable year involved with any of the courts described in subsection (a).

(2) PRIORITY OF THE TAX COURT ACTION.—If more than 1 action is brought under paragraph (1) with respect to any partnership for any partnership taxable year, the first such action brought in the Tax Court shall go forward.

(3) PRIORITY OUTSIDE THE TAX COURT.—If more than 1 action is brought under paragraph (1) with respect to any partnership for any taxable year but no such action is brought in the Tax

Service has mailed a notice of FPAA to the tax matters partner, the tax matters partner may file a petition for readjustment of the partnership items in the Tax Court. Sec. 6226(a). The tax matters partner is the general partner designated as such or if there is no designation, the general partner having the largest profits interest in the partnership (sec. 6231(a)(7)). Here, because petitioner is the only general partner in each partnership, it is the tax matters partner in each partnership. Thus, petitioner has 90 days from June 18, 1984, in which to file each petition as a tax matters partner. Sec. 6226(a).

If the tax matters partner does not file a petition within 90 days, "*any* notice partner" may file a petition within 60 days after the close of the 90-day period. Sec. 6226(b). (Emphasis supplied.) Section 6231(a)(8) defines a notice partner as one who is entitled to notice under section 6223(a), that is any partner in a partnership with 100 or fewer partners, and a partner with a 1-percent or greater profits interest in a partnership with more than 100 partners.[10] Petitioner also satisfies the requirements for being a notice partner in both Barbados #6 Ltd., a partnership with fewer than 100 partners, and in Barbados #5 Ltd., which has more than 100 partners. We therefore find as a fact that petitioner is a notice partner in each partnership.

The issue in these cases is whether a timely petition was filed by petitioner. Respondent would have us create two distinct time periods for filing and separate the eligibility of petitioner from other notice partners for filing a petition during the later period. While we agree that the statute creates a two-tiered system for filing, we do not think the TEFRA provisions preclude a notice partner who is also the tax matters partner from filing as a notice partner. As such, we hold that petitioner as a notice partner, timely filed the petitions within the 60-day period provided in section 6226(b)(1).

Court, the first such action brought shall go forward.

(4) DISMISSAL OF OTHER ACTIONS.—If an action is brought under paragraph (1) in addition to the action which goes forward under paragraph (2) or (3), such action shall be dismissed.

(5) TAX MATTERS PARTNER MAY INTERVENE.—The tax matters partner may intervene in any action brought under this subsection.

[10] Respondent concedes that Bajan Services, Inc., satisfies all the requirements for being a notice partner, and in fact sent the corporation notices pursuant to sec. 6223(a).

This result is compelled by section 6226(b)(1) which provides that *any* notice partner may file a petition in the Tax Court within 60 days after the close of the 90-day period in which the tax matters partner may petition the Court. We take this to mean that if the tax matters partner is also a notice partner, then the tax matters partner may also petition the Court as a notice partner within the 60-day period after the expiration of the 90-day period.

We agree with respondent that as the tax matters partner, petitioner failed to timely file a petition since a petition was not filed within the 90-day period. However, respondent overlooks the fact that a notice partner may file a petition within 60 days after the 90-day period has expired in those cases where the tax matters partner fails to file a petition under section 6226(a). Sec. 6226(b)(1). Also, respondent ignores the fact that an entity or an individual may be both a tax matters partner and a notice partner. To follow respondent's reasoning, a notice partner would forfeit his right to file a petition on his own behalf if he was also the tax matters partner. We find no statutory support for such reasoning.

The scheme of the statute is designed to make certain all partners have an opportunity to litigate a dispute with the Internal Revenue Service including a notice partner who may also happen to be the tax matters partner. It is true that since petitioner is the only general partner, the statute provides that it be the tax matters partner. However, we do not conceive that this particular factual situation requires that its rights as a notice partner be forfeited and we do not think the statute intended such a result. Consider the factual situation where the tax matters partner, who also is a notice partner, is precluded from filing a petition by those controlling the partnership. If we follow respondent's reasoning, such individual would be precluded from filing a petition to protect his own rights as a notice partner. In essence, we are simply saying here that petitioner wore two hats—one as the tax matters partner and another as a notice partner. Since a timely petition was not filed by petitioner as the tax matters partner, we see no statutory prohibition which precludes petitioner from proceeding on its own behalf by filing a petition as a notice partner.

In reaching our result, we are mindful that the heading of section 6226(b) reads, "Petition by Partner Other Than Tax Matters Partner." However, we view this section heading as a general description of the context in which the majority of petitions would be filed under section 6226(b). This is so since many tax matters partners may not own the requisite interest to qualify as a notice partner, and in those cases where a tax matters partner also qualifies as a notice partner, the petition would most likely be filed pursuant to section 6226(a).[11] We also have taken cognizance of our own Rules of Practice and Procedure which provide instructions with respect to petitions filed by "a partner other than the tax matters partner." Rules 240(c)(1) and 241(d)(3). However, these rules were promulgated to provide procedural guidance only and were not intended to limit judicial review authorized by section 6226.

The thrust of the statutory scheme is to get the partnership and all interested partners into court in one proceeding so that time and resources will not be wasted in needless, repetitive litigation. Although this scheme allows extra leeway in those situations such as the present one where the tax matters partner is also a notice partner, it insures that the partnership will have its prepayment day in the Tax Court.[12] Allowing a notice partner, who is also the tax matters partner, to file a petition as a notice partner advances the purpose of the statute. We wish to point out, however, that a petition filed under section 6226(b) by the notice partner/tax matters partner would be entitled to no more priority under section 6226(b)(2) and (3) than a petition filed by any other notice partner.

Having drawn a conclusion in favor of petitioner, we hasten to reject most of the contentions petitioner puts forward in support of its position. First, we cannot agree that the June 25 notice of FPAA sent to the notice partners, including petitioner, superseded the June 18 notice of FPAA sent to the tax matters partner. Although the June 18 notice was sent to Mr. Jensen, it is clear that the notice was intended for him as president of the general (tax matters) partner. The second notice could only have been sent to Bajan Services, Inc., therefore, to meet the notice requirements of section 6223(a)(2) and (d)(2). Also, because the Internal Revenue Service is precluded from sending a second notice of FPAA without a showing of fraud, malfeasance, or misrepresentation of a material fact, it would gut the limitations period if we were to find that the second notice superseded the first.[13]

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[11] If the section heading cannot be so construed, we nevertheless decline to limit the plain meaning of the text. The title of a statute or heading of a section cannot limit the text of the statute. *United States v. Minker*, 350 U.S. 179, 185 (1956); *Pike v. United States*, 340 F.2d 487, 489 (9th Cir. 1965); cf. *Renstrom v. United States*, 220 F. Supp. 688 (D. Neb. 1963). See sec. 7806(b).

[12] Indeed to hold otherwise would verge on the unconscionable in these circumstances for it would effectively deny any judicial review at the partnership level in these cases since a subsequent petition filed with the United States District Court or Claims Court would not be timely. Sec. 6226(a) and (b).

Nor do we agree with petitioner's argument that, because the Internal Revenue Service sent out the second notice, which contains the exact wording as the first notice, the two notices somehow contradict each other, and only the second notice is operative. Petitioner's reliance on *Pyo v. Commissioner*, 83 T.C. 626 (1984), for this proposition is misplaced. In *Pyo*, the Commissioner mailed a notice of deficiency to the taxpayers at an address shown on their income tax returns for the years at issue. Prior to mailing this notice, however, the same District Director's Office corresponded with the taxpayers at a different address, which was also shown on returns for later years. Dismissing the case for lack of jurisdiction because there was no valid deficiency notice, the Court held that the taxpayers had satisfied their duty to notify the Commissioner of their change of address, and that the Commissioner had not exercised reasonable diligence in ascertaining the taxpayers' last known address.

The situation in the cases before us is completely different from that in *Pyo*. The June 18 notice of FPAA for each partnership was sent to the general partner. The fact that the general partner's attorneys responsible for preparing and mailing the petition in each case inadvertently used the June 25 notice in determining the 90-day period does not nullify the effect of the first notice. The notice clearly states at the top, "Date FPAA Mailed to Tax Matters Partner: June 18, 1984." Moreover, the body of the notice contains the following statement:

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[13] Sec. 6223(f). The two notices mailed to petitioner were identical albeit one was directed to petitioner as the tax matters partner on June 18, 1984, and the other was directed to petitioner as a notice partner on June 25, 1984. Because of the identical language, it is our opinion that the notice mailed on June 25, 1984, does not constitute a second notice proscribed by sec. 6223(f).

> If the Tax Matters Partner has not filed a petition by the 90th day from the date the FPAA was mailed, any other partner entitled to receive this notice * * * may petition one of the above Courts after the 90th day but on or before the 150th day from the mailing date of the FPAA to the Tax Matters Partner *as shown above*.[14] [Emphasis added.]

Although this notice is not a model of clarity, it in fact alerted petitioner to the importance of the June 18 notice.

Petitioner alleges that the June 25 notice of FPAA explicitly stated that it commenced the 90-day period during which to file a petition in each case. Petitioner cites *Skaneateles Paper Co. v. Commissioner*, 29 B.T.A. 150 (1933), and other cases, to support its argument that it should be able to rely on this statement in the June 25 notice. But *Skaneateles Paper* did not involve the same deficiency notice sent to the same taxpayer in two different capacities; hence, that decision is not pertinent here, and petitioner's contention on this point is rejected. In *Skaneateles Paper*, the Commissioner specifically mentioned in a separate communication to the taxpayer, that it should disregard the provisions of the first notice. Several months later, the Commissioner sent another deficiency notice with a different amount of tax liability for the same years. In the present case, the June 25 notice referred to the June 18 notice in two different places and explained the procedures a notice partner should follow if the tax matters partner failed to file a petition within the 90-day period.

Petitioner also asserts that the filing of the petitions in these cases tolled the 60-day period in which a notice partner could file a petition under section 6226(b)(1). Thus, petitioner argues, any notice partner should be able to come into the case as a named party to cure defects in the originally filed petition. It is true that an amended petition relates back to the time of filing of the original petition. *Derksen v. Commissioner*, 84 T.C. 355, 359 (1985); see also Rule 41(d). It is also true that in certain circumstances we have allowed a third party to file a petition in the Court on behalf of the taxpayer. See, e.g., *Gray v. Commissioner*, 73 T.C. 639 (1980); *Beatty v. Commissioner*, T.C. Memo. 1980-168. These are not cases in which either of these issues need be considered, however, because we have found that petitioner filed timely petitions as a notice partner.

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[14] We note that the language in this notice stating that "any other partner entitled to receive this notice is incorrect insofar as it purports to prohibit the tax matters partner, also a notice partner, from petitioning the Court during the later, 60-day period.

Respondent's attorney stated at oral argument on these motions, that he does not object to the petitioner's motions to file amended petitions if the Court finds that the petitions were timely filed and we deem it appropriate.[15] Upon further consideration of these records, we deem it not appropriate to grant petitioner's motions. In our view, the sole purpose in filing the amended petitions would be to add the names of notice partners C. Martin Unterreiner, Kenneth R. Haley, and Marilyn R. Haley in order to cure the original petitions. This is wholly unnecessary since petitioner is before the Court in each case as a notice partner. Moreover, we direct petitioner's attention to section 6226(c) and (d) which provides that each partner that has an interest in the outcome of an action brought under section 6226(a) or (b) shall be treated as a party to the action and be allowed to participate in the action. Pursuant to our Rules, a partner may participate in the action by filing with the Court a notice of election to participate setting forth facts establishing that such partner satisfies the requirements of section 6226(d). Rule 244(b). The notice of election to participate is required to be filed with the Court within 210 days from the date of mailing of the FPAA to the tax matters partner; however, with leave of this Court *upon a showing of sufficient cause*, a notice of election to participate in the proceeding may be filed out of time. Rule 244(b) and (c). Should C. Martin Unterreiner, Kenneth R. Haley, and Marilyn R. Haley or any other notice partner want to participate in these cases, appropriate notices of election that comply with the directives of these Rules should be filed.[16] Petitioner's motions will be denied.

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[15] This is petitioner's second request to amend its petitions. On Mar. 4, 1985, and Mar. 11, 1985, respectively, this Court granted petitioner's motions, filed Feb. 25, 1985, to amend the petitions herein to conform to Rule 241 by appending a copy of the notice required to be served by the tax matters partner on each partner and a certificate of such service. See Rule 241(d)(2)(ii) and (f)(1).

[16] Of course, any such notice must be accompanied by a motion for leave to file same out of time which sets forth a showing of sufficient cause.

These cases are at issue before the Court, since respondent filed timely answers on December 7, 1984. Rule 38. They shall now be moved forward to trial or other disposition.

Appropriate orders will be issued.

Reviewed by the Court.

SIMPSON, GOFFE, WILBUR, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, COHEN, SWIFT, JACOBS and WRIGHT, *JJ.*, agree with the majority opinion.

GERBER, *J.*, did not participate in the consideration of this case.

STERRETT, *Chief Judge*, dissenting: I respectfully dissent. The majority opinion holds that petitioner-tax matters partner (TMP) filed a timely petition with the Tax Court by acting in the capacity of a notice partner. This holding effectively grants to that person designated as the TMP a 150-day period to petition the Court, rather than the 90-day period set forth in section 6226, I.R.C. 1954.

Subsection (a) of section 6226 provides that, during the 90 days following the mailing of a final partnership administrative adjustment (FPAA), only the TMP may file a petition for readjustment. Subsection (b) of section 6226 provides that, in the event the TMP fails to so act, then within the succeeding 60 days any notice partner or 5-percent group may file a petition. I disagree with the majority's conclusion that the TMP may, alternatively, file a petition pursuant to subsection (b) as a notice partner.

The new partnership audit provisions (secs. 6221–6233), require all partners to treat partnership items consistently with their treatment on the partnership return (sec. 6222(a)), unless the Service receives notice of any inconsistency (sec. 6222(b)). The Service is authorized to conduct its audit at the partnership level (sec. 6223). This unified proceeding is to avoid duplicative efforts and inconsistent treatment by the various partners, particularly in large partnerships whose partners reside in numerous jurisdictions or who file returns based on different taxable years. An integral feature of this statutory scheme, designed to achieve uniformity, is the designation of one partner as the TMP pursuant to section 6231(a)(7). This case presents the Court's first opportunity to interpret the role of the TMP.

The TMP has a duty to act on behalf of the partnership. See, for examples, secs. 6223(g), 6224(c)(3), 6227(b), 6228(a), 6229(b)(1)(B), and 6230(e). Other members of the partnership may qualify as "notice partners" (sec. 6231(a)(8)), who enjoy certain rights, for example, to receive notices of administrative proceedings (sec. 6223(a)), and who need not be bound by a settlement agreement entered into by the TMP (sec. 6224(c)(3)).

The issue presented is whether the TMP has filed a timely petition under section 6226(b) as a notice partner. I would conclude, contrary to the majority, that the partner who is afforded the duties and responsibilities of the TMP cannot, alternatively, act in the capacity of a notice partner for other purposes of the partnership audit. The legislative history of section 6226 refers to notice partners as separate and distinct from the TMP. The Conference Committee report states:

> If the TMP does not file a petition, any notice partner or 5-percent group with an interest in the outcome may within 60 days following such 90-day period, file a petition with any of the courts in which the TMP may file a petition. * * * [H. Rept. 97-760, (Conf.) (1982), 1982-2 C.B. 600, 664.]

The TMP is reserved the right to intervene in any action commenced under this subsection (b) (sec. 6226(b)(5)); as the Conference report states, "The TMP may intervene in an action brought by another partner." H. Rept. 97-760, *supra*.

The majority opinion notes that the heading of section 6226(b) refers to a "Petition by Partner Other Than Tax Matters Partner." This need not be interpreted as "a general description of the context in which the majority of petitions would be filed under section 6226(b)," as the majority contends (p. 906), but rather as the statutory scheme devised by Congress; only the TMP may file a petition pursuant to section 6226(a), and only notice partners and 5-percent groups may file a petition pursuant to section 6226(b). Congress did not provide that subsection (b) applies to the TMP as well. For comparison, section 6226(g) provides, "With respect to the partnership, only the tax matters partner, a notice partner, or a 5-percent group may seek review of a determination by a court under this section." Also, section 6228(a)(6) provides, "With respect to the partnership, only the tax matters partner, a notice partner, or a 5-percent group may seek review of a determination by a court under this subsection." The majority opinion also notes that the Tax Court's own Rules of Practice and Procedure distinguish between a petition filed "by the tax matters partner within the period specified in Code Section 6226(a)," as compared to a petition filed "by a partner other than the tax matters partner subject to the conditions and within the period specified in Code Section 6226(b)." Rule 240(c)(1)(ii). Each partner is entitled to only one notice of the final partnership administrative adjustment, absent fraud, malfeasance, or misrepresentation of fact (sec. 6223(f)); petitioner is not entitled to receive one notice as the TMP and a second notice in the "capacity of a notice partner."

The majority opinion states that the statutory scheme is designed to ensure all partners the opportunity to litigate a dispute with the Service (p. 906). However, these audit provisions are designed to litigate disputes involving partnership items by a single audit, in a unified partnership proceeding, since all partners must report partnership items consistently with the partnership return. When a petition is filed by the TMP pursuant to section 6226(a), or by a notice partner pursuant to section 6226(b), all partners with an interest in the outcome are deemed to be parties to the action (sec. 6226(c) and (d)), just as all partners have the right to participate in any administrative proceeding (sec. 6224(a)). The statute encourages the TMP to act on behalf of the partnership by providing the initial 90-day period in which only the TMP may commence its action. So as not to impair the rights of the other partners, an additional 60 days is provided to commence an action should the TMP fail to file a petition in the first instance.

The majority opinion expresses great concern over a hypothetical situation in which the TMP is precluded from filing a petition and therefore is unable to protect its own interest as a partner. There are no facts in this case which indicate that the TMP's rights have been so impaired, or that petitioner was unable to file its petition during the initial 90 days. Given that a Federal statute provides the authority to the TMP to petition the Court, it appears unlikely that this statute would be superseded by a State law or partnership agreement provision to the contrary. If petitioner had intended to treat a partnership item differently on his own return from its treatment on the partnership return, he could have done so and notified the Service of this treatment under section 6222(b).

Petitioner-TMP failed to file its petition within 90 days after the mailing of the FPAA. Since a timely petition was not filed, the Court lacks jurisdiction and respondent's motion to dismiss should be granted.

HAMBLEN and CLAPP, *JJ.*, agree with this dissent.

HAMBLEN, *Judge*, dissenting: I also respectfully dissent as I thoroughly agree with the dissent of Chief Judge Sterrett. The majority opinion holds that a tax matters partner (TMP) who fails to timely file a petition within the 90-day provision of section 6226(a), may timely file a petition with the Tax Court as a notice partner within the 60-day provision of section 6226(b). The majority result operates to extend the filing period provisions of section 6226 to 150 days as to the designated TMP. Thus, the majority here holds that a TMP who intended to file a petition within the 90-day provision of section 6226(a) and so designates such petition as filed by the TMP, but inadvertently failed to timely file such petition within the 90-day provision of 6226(a), may cure the ills of such inadvertence merely by redesignating the petitioner status as that of a notice partner within the 60-day provisions of section 6226(b). My view is that Congress intended to preclude a TMP from such dual status for purposes of filing a petition under section 6226.

My conclusion is founded upon a commonsense approach of statutory interpretation under section 6226. The heading of section 6226(b) refers to a "Petition by Partner Other Than Tax Matters Partner." The majority correctly states that the title of a statute or a heading of a section cannot limit the text of a statute. While this statement is correct, titles and headings may be of aid in resolving an ambiguity within the statutory text. See 1 J. Mertens, Law of Federal Income Taxation, sec. 3.19, at 32 (1981 rev.) Here, the statute is somewhat ambiguous as section 6226(b)(1) refers to any notice partner, however, section 6226(b)(5) further provides that the TMP may intervene in any action filed by a notice partner. In my view, the intent of Congress was to preclude dual partner status under section 6226(a) and (b) for purposes of petition for judicial review, as is evident within the purview of section 6226(b)(5), where Congress provided the TMP a right to intervene in any action commenced by a notice partner under section 6226(b). I cannot reconcile the logical sequence of these provisions with the opinion adopted by the majority, and I simply cannot believe Congress would engage in such an extensive exercise in semantics, considering section 6226 in its entirety, simply to provide a TMP 150 days to file a petition here while limiting notice partners to 60 days.

STERRETT, *C.J.*, agrees with this dissent.

WILLIE NELSON MUSIC COMPANY, PETITIONER *V.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

WILLIE H. NELSON AND CONNIE (CONSTANCE) NELSON, PETITIONERS *V.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 1174–85, 1193–85. Filed December 12, 1985.

Ps seek to seal records up to the time of trial to prevent annoyance, embarrassment, and oppression. *Held*, requisite good cause not shown, therefore, Ps' motions to seal denied. Rule 103, Tax Court Rules of Practice and Procedure.

William R. Cousins III, for the petitioners.

Stephen M. Miller and *Marty J. Raisanen* for the respondent.

OPINION

CANTREL, *Special Trial Judge*: These cases are before the Court on petitioners' motions to seal filed in each case on May 16, 1985.[1] They were called for hearing at Washington, D.C. on June 5, 1985, at which time counsel for the parties appeared and presented argument. At the conclusion of the hearing, the Court took the motions under advisement.

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[1] The cases were assigned pursuant to sec. 7456(c)(4), I.R.C. 1954 as amended, and Delegation Order No. 8 of this Court, 81 T.C. XXV (1983).

Respondent, in his notice of deficiency issued on October 15, 1984 to Willie Nelson Music Company, petitioner in docket number 1174–85, determined the following deficiencies and additions to tax:

				Additions to tax, I.R.C. 1954		
Year	*Income tax*	*Personal holding company tax*	*Total*	*Sec. 6651(a)*[2]	*Sec. 6653(b)*	*Sec. 6654*
1972	$1,288	$3,198	$4,486	$1,122	0	$130
1973	5,333	13,234	18,567	4,642	0	537
1974	7,610	15,250	22,860	5,715	0	661
1975	6,387	17,443	23,830	0	$11,915	0
1976	16,589	32,268	48,857	0	24,429	0
1977	20,145	34,964	55,109	0	27,555	0
1978	58,396	63,972	122,368	0	61,184	0
	$115,748	180,329	296,077	11,479	125,083	1,328

Willie Nelson Music Co., a Tennessee corporation, had its principal office in Danbury, Connecticut, on the date its petition was filed.

Respondent, in his notice of deficiency issued on October 15, 1984, to petitioners Willie H. Nelson[3] and Connie Nelson, petitioners in docket number 1193–85, determined the following deficiencies and additions to tax:

		Additions to tax, I.R.C. 1954	
Years	*Income tax*	*Sec. 6653(b)*	*Sec. 6653(a)*
1975	$259,775	$141,995	0
1976	405,180	283,312	0
1977	384,389	305,290	0
1978	465,408	0	$23,270.40
	1,514,752	730,597	23,270.40

Petitioners in docket number 1193–85 were residents of Austin, Texas, at the time they filed their petition.

On January 15, 1985, petitions in both dockets were filed.[4] On March 15, 1985, respondent filed a motion to extend the time within which to answer. Respondent's motion was granted on March 20, 1985 extending his answer due dates to

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[2] All section references are to the Internal Revenue Code of 1954 as amended.

[3] Willie H. Nelson is a nationally known country music star.

[4] Both petitions were timely mailed by certified mail on Jan. 11, 1985, and, thus, timely filed. See sec. 7502.

May 20, 1985. On May 16, 1985, petitioners filed identical motions to seal pursuant to Rule 103(a).[5] On May 24, 1985, respondent filed his memorandum of law in opposition to motions to seal. Petitioners filed a reply to respondent's memorandum of law on June 3, 1985.

In their motions to seal, petitioners seek a protective order sealing the entire record of both cases (including but not limited to all pleadings, depositions, exhibits, papers, and filings) to be opened only by order of the Court and directing that the parties and their counsel in these cases be prohibited from disclosing to the media or public the contents of the sealed records. At the hearing, petitioners' counsel modified his motions in requesting that the records be sealed only up to the time of trial.[6]

In support of their motions, petitioners argue that Willie H. and Connie Nelson as nationally known personalities are subject to "intense and continual" scrutiny by the media. The Willie Nelson Music Co. (hereinafter referred to as the company) is wholly owned and controlled by Willie H. and Connie Nelson, and, as a result, the company is also subject to "intense and continual" scrutiny by the media. Petitioners contend that the media coverage has attached undue credibility to respondent's allegations and has resulted in wide publicity and sensationalization. Thus, petitioners assert that they have been seriously and irreparably damaged by the public's impressions. Petitioners maintain that the damage is caused in part by newspaper headlines which indicate that petitioners are subject to criminal prosecution,[7] thus causing petitioners undue embarrassment and considerable emotional distress. Additionally, petitioners urge that, as a result of the publicity, they have been financially injured in that now they are unable to negotiate large up front payments in long-term endorsement contracts.

Respondent opposes petitioners' motions and argues that common law, statutory law, and the Constitution require that the motions be denied.

Our research has failed to disclose any reported Tax Court case where the fraud additions to tax have been determined and the record was sealed, nor has any such case been advanced by the parties. Since Rule 103(a) is derived from Rule 26(c), Federal Rules of Civil Procedure, we have looked to decisions interpreting Rule 26(c), Fed. R. Civ. P., for guidance in our decision herein.[8]

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[5] All Rule references are to the Tax Court Rules of Practice and Procedure.

[6] Indeed, the parties agree that an open trial should be conducted.

[7] There is no criminal case pending against either of the petitioners.

Rule 103(a) provides, in relevant part:

> RULE 103. PROTECTIVE ORDERS
>
> (a) Authorized Orders: *Upon motion by a party or any other affected person, and for good cause shown, the Court may make any order which justice requires to protect a party or other person from annoyance, embarrassment, oppression, or undue burden or expense*, including but not limited to one or more of the following:
>
> * * * * * * *
>
> (6) That a deposition *or other written materials*, after being sealed, be opened only by order of the Court.
>
> (7) That a trade secret *or other information* not be disclosed or be disclosed only in a designated way.
>
> (8) That the parties simultaneously file specified documents or information enclosed in sealed envelopes to be opened as directed by the Court.
>
> [Emphasis added.]

As a general rule, common law, statutory law, and the U.S. Constitution support the proposition that official records of all courts, including this Court, shall be open and available to the public for inspection and copying. *Nixon v. Warner Communications, Inc.*, 435 U.S. 589, 597 (1978) (where a transcript of some 22 hours of tape recordings was furnished to reporters, but, release of Watergate tapes used as evidence in criminal trial to copy, broadcast, and sell denied); *In re Coord. Pretrial Proc. in Pet. Prod. Antitrust*, 101 F.R.D. 34, 38 (C.D.Cal. 1984) ("umbrella" protective order partially lifted and only that material which contained trade secrets or was actually commercially sensitive was to remain subject to protection); *In re*

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[8] See 60 T.C. 1122–1123 (1973), and Rule 1(a); see also *Espinoza v. Commissioner*, 78 T.C. 412, 415–416 (1982), and cases cited therein. Rule 26(c), Fed. R. Civ. P., which is quite similar to Rule 103(a), recites in pertinent part:

> (c) Protective Orders. Upon motion by a party or by the person from whom discovery is sought, *and for good cause shown*, the court in which the action is pending or alternatively, on matters relating to a deposition, *the court in the district where the deposition is to be taken may make any order which justice requires to protect a party or person from annoyance, embarrassment, oppression, or undue burden or expense*. * * * [Emphasis added.]

Mosher, 45 C.C.P.A. 701, 248 F.2d 956, 959 (1957), and cases cited therein (where the court directed its clerk to provide copies of decision of Patent Office Board of Appeals as set forth in the transcript of record filed in patent appeal); section 7461.[9] However, the right to inspect and copy judicial records is not absolute.[10] *Nixon v. Warner Communications, Inc., supra* at 598–599;[11] *Brown & Williamson Tobacco Corp. v. F.T.C.*, 710 F.2d 1165, 1179 (6th Cir. 1983).[12]

It is beyond question, and petitioners agree, that this Court has broad discretionary power to control and seal, if necessary, records and files in its possession, and the standard for review thereof is for abuse of discretion. *Belo Broadcasting Corp. v. Clark*, 654 F.2d 423, 430–434 (5th Cir. 1981);[13] *Nixon v. Warner Communications, Inc., supra* at 598; *Crystal Grower's Corp. v. Dobbins*, 616 F.2d 458, 461 (10th Cir. 1980) (documents claimed to be privileged under the attorney-client privilege and work product immunity doctrine remain under seal); secs. 7458[14] and 7461; Rule 103(a). In the instant cases, to determine whether the sealing of these records in any manner is appropriate, in exercising our discretion, we must weigh the interests of the public, which are presumptively paramount against those advanced by the parties. *Nixon v. Warner Communications, Inc., supra* at 602; *Crystal Grower's Corp. v. Dobbins, supra* at 461; *Coe v. U.S. Dist. Court for Dist. of Colorado*, 676 F.2d 411, 414 (10th Cir. 1982); *In re Agent Orange Product Liability Litigation*, 98 F.R.D. 539, 545 (E.D.N.Y. 1983) (only materials filed in connection with specific summary judgment motions unsealed).

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[9] Sec. 7461, appertaining to the publicity of proceedings states, in relevant part—

> SEC. 7461(a). GENERAL RULE.—Except as provided in subsection (b), all reports of the Tax Court and all evidence received by the Tax Court and its divisions, including a transcript of the stenographic report of the hearings, shall be public records open to the inspection of the public.
>
> (b) EXCEPTIONS.—
>
> (1) TRADE SECRETS OR OTHER CONFIDENTIAL INFORMATION.—The Tax Court may make any provision which is necessary to prevent the disclosure of trade secrets or other confidential information, including a provision that any document or information be placed under seal to be opened only as directed by the court.

We wish to emphasize that trade secrets are not involved here nor have petitioners advanced that "other confidential information" is involved.

[10] For a general discussion of the public nature of judicial proceedings, see *Ex Parte Drawbaugh*, 2 App. D.C. 404, 406 (1894) (where the court said that the record in its court relating to an appeal is subject to public inspection and exemplification); Wilder, "All Courts Shall Be Open," 52 Temp. L. Q. 311, 337 (1979).

[11] In *Nixon v. Warner Communications, Inc.*, 435 U.S. 589, 598 (1978), the Supreme Court provides examples of situations (citing cases) where inspection was not allowed, e.g., where a record disclosed "the painful and sometimes disgusting details of a divorce case" or where opening a record may serve as a reservoir of libelous statements for press consumption.

[12] While acknowledging that the right of access is not absolute, the court in *Brown & Williamson Tobacco Corp. v. F.T.C.*, 710 F.2d 1165 (6th Cir. 1983), vacated an order sealing documents which was based upon a confidentiality agreement of the parties. The court observed, "This desire, [to shield prejudicial information contained in judicial records] however, cannot be accommodated by courts without seriously undermining the tradition of an open judicial system." *Brown & Williamson Tobacco Corp. v. F.T.C., supra* at 1180.

[13] In *Belo Broadcasting Corp. v. Clark*, 654 F.2d 423 (5th Cir. 1981), the court held that the lower court did not abuse its discretion in denying broadcasters access to audiotapes, when that denial was grounded on the right of a yet-to-be tried defendant to a fair trial. We note that *Belo Broadcasting* involved a criminal trial by jury: we have no such factual situation in these cases.

[14] Sec. 7458, respecting hearings provides in salient part—

> Hearings before the Tax Court and its divisions shall be open to the public, and the testimony, and, *if the Tax Court so requires*, the argument, shall be stenographically reported. * * * [Emphasis supplied.]

In these cases, members of the public have an interest in free access to the facts and in understanding disputes that are presented to this forum for resolution. They also have an interest in assuring that courts are fairly run and judges are honest.[15] *Coe v. U.S. Dist. Court for Dist. of Colorado, supra* at 414; *Crystal Grower's Corp. v. Dobbins, supra* at 461. Nevertheless, the presumptive right to access may be rebutted by a showing that there are countervailing interests sufficient to outweigh the public interest in access.

For example, where a motion to seal encompasses documents governed by the attorney work-product privilege or the contents of communications subject to the attorney-client privilege, the public interest in protecting those privileges would take precedence over the interest to inspect and copy court records. *In re Agent Orange Product Liability Litigation, supra* at 545, and cases cited therein; *Crystal Grower's Corp. v. Dobbins, supra* at 462. If disclosure of documents would amount to use of the court process for gratification of private spite or public scandal, then the public's interest in its right of access diminishes. *Nixon v. Warner Communications, Inc., supra* at 598, and cases cited therein. Additionally, the constitutional right to privacy in avoiding disclosure of personal matters may outweigh the public's right of access. *Tavoulareas v. Washington Post Co.*, 724 F.2d 1010, 1017–1021 (D.C. Cir. 1984), and cases there cited (where it was held that a corporation had a constitutionally protected privacy interest in avoiding public disclosure of sensitive commercial information not used at trial of a libel action); *Plante v. Gonzalez*, 575 F.2d 1119, 1132–1137 (5th Cir. 1978), cert. denied 439 U.S. 1129 (1979);[16] cf. *Coe v. U.S. Dist. Court for Dist. of Colorado, supra.*[17]

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[15] It is arguable that the right of access to records may be more important than the right to observe the judicial process, because it allows examination of documents, pleadings, and transcripts which portray a more complete picture of the official development and resolution of a case. Wilder, "All Courts Shall Be Open," 52 Temp. L. Q. 311, 338 (1979), and cases cited therein.

Public interests are weighed against those advanced by the party seeking the protective order, and, in its discretion, a court may seal the record or portions thereof where justice so requires and the party seeking such relief *demonstrates good cause. American Telephone & Telegraph Co. v. Grady*, 594 F.2d 594, 596 (7th Cir. 1979); Rule 103(a). However, a party may not rely on mere conclusory statements or his attorney's unsupported self-serving hearsay statements to establish good cause. *In re Coord. Pretrial Proc. in Pet. Prod. Antitrust, supra* at 44; *Sacks v. Frank H. Lee Co.*, 18 F.R.D. 500, 501 (S.D.N.Y. 1955). In *Sacks*, the court stated that the affidavit of plaintiff's attorney was "an utterly insufficient showing that the testimony sought will betray any secrets."

A party must come forth with appropriate testimony and factual data to support claims of harm that would occur as a consequence of disclosure. *Wyatt v. Kaplan*, 686 F.2d 276, 283 (5th Cir. 1982);[18] *United States v. United Fruit Co.* 410 F.2d 553 n. 11 (5th Cir. 1969) (protective order prohibiting disclosure of divestiture plans upheld where affidavit was supported with numerous examples of harm that would occur upon disclosure). In *Apco Oil Corp. v. Certified Transportation, Inc.*, 46 F.R.D. 428, 432 (W.D. Mo. 1969), the court said, "It is not necessary to add that the burden of proof will rest upon plaintiff at such a hearing and that the determination of whether good cause does or does not exist must be based upon appropriate testimony and other factual data, *not the unsupported contentions and conclusions of counsel.*" (Emphasis supplied.)[19]

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[16] After comparing the public's interest in access to the plaintiff's right to privacy, the court in *Plante v. Gonzalez*, 575 F.2d 1119 (5th Cir. 1978), opined, inter alia, that mandatory financial disclosure for elected officials is constitutional.

[17] We observe that venue on appeal of docket No. 1193–85, without a stipulation to the contrary (see sec. 7482(b)(2)), lies in the U.S. Court of Appeals for the Fifth Circuit. Sec. 7482(b)(1)(A).

[18] Wyatt involved an action brought for conspiracy to commit libel and slander, where the court said "Courts do not generally grant protective orders without a strong showing of 'good cause.' "

[19] See and compare *Penn-Field Industries, Inc. v. Commissioner*, 74 T.C. 720 (1980), where we granted respondent's motion for protective order on the grounds that a discovery request was "clearly burdensome" and *no evidence* was presented by the opposing party to justify their claim.

Historically, good cause has been demonstrated and records sealed where patents, trade secrets, or confidential information are involved.[20] However, a showing that the information would harm a party's reputation is generally not sufficient to overcome the strong common law presumption in favor of access to court records. "Indeed, common sense tells us that the greater the motivation a corporation has to shield its operations the greater the public's need to know." *Brown & Williamson Tobacco Corp. v. F.T.C., supra* at 1179–1180.

In *Application of Sarkar*, 575 F.2d 870 (C.C.P.A. 1978), a patent application proceeding, the court granted Sarkar's motion to seal the record. The court found that the seal was justified by Sarkar's *showing* that the application contained material constituting a trade secret. Thus, to encourage patent applicants to pursue their rights to patents and provide the public with early disclosure of inventions, the court determined that legitimate trade secrets must be protected. *Application of Sarkar, supra* at 872.

Courts also acknowledge that confidential business information (e.g., pricing information, customer lists, sales volume) requires protection. The rationale in granting protective orders where documents contain this type of information is that if these facts were disclosed, the moving party would suffer great competitive disadvantage and irreparable harm. *Essex Wire Corp. v. Eastern Electric Sales Co.*, 48 F.R.D. 308, 310 (E.D. Pa. 1969) (subject matter of protective arrangement between one defendant and foreign supplier, the release of which would cause great competitive disadvantage, protected); *Doe v. A Corp.*, 709 F.2d 1043 (5th Cir. 1983) (house counsel, after resignation, barred by his ethical obligations as a lawyer from prosecuting litigation as class representative of other employees; case records sealed); *Chesa Intern., Ltd. v. Fashion Associates, Inc.*, 425 F. Supp. 234 (S.D.N.Y. 1977) (protective order issued to protect defendant's competitive position); *Covey Oil Co. v. Continental Oil Co.*, 340 F.2d 993 (10th Cir. 1965) (non-party witnesses required to comply with subpoena duces tecum requesting trade secrets relating to price, cost, and volume of sales of gasoline; however, use thereof for business or competitive purposes proscribed); *Ames Co. v. Bostitch, Inc.*, 235 F. Supp. 856 (S.D.N.Y. 1964) (limited protective order issued).[21] In all these cases access to the protected documents was granted, but the extent to which the parties could use them was limited by the courts. Hence, from these cases it is clear that the paramount concern is to accord the parties access to all relevant and necessary information so that they can adequately prepare their cases without permitting improper or unfair use of the materials produced. See, e.g., *Boeing Airplane Co. v. Coggeshall*, 280 F.2d 654 (D.C. Cir. 1960), which involved three appeals from orders by the District Court on motions relating to a petition to enforce a subpoena duces tecum issued by the Tax Court. Boeing wanted the documents for its own use and the Tax Court's use in a proceeding before the Tax Court under section 108 of the Renegotiation Act of 1951. There the court found that enforcement of the subpoena was warranted, but said the District Court could properly examine in camera individual papers for stated purposes, e.g., privilege, trade secrets.

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[20] Other areas in which courts have granted protective orders are where documents concern national security, law enforcement, and governmental activities. See *Alliance To End Repression v. Rochford*, 75 F.R.D. 431 (N.D. Ill. 1976); *Ronson Corp. v. Liquifin Aktiengesellschaft*, 370 F. Supp 597 (D.N.J. 1974).

Courts have not only accorded business entities' "confidential" information protection but have also issued protective orders to protect an individual's confidentiality and right to privacy. *Sendi v. Prudential-Bache Securities*, 100 F.R.D. 21 (D.D.C. 1983); *In re Smith*, 656 F.2d 1101 (5th Cir. 1981); *In re Caswell*, 18 R.I. 835, 29 A. 259 (1893) (where the court in holding that no one has a right to examine or obtain copies of public records from mere curiosity, or for the purpose of creating public scandal, refused to turn over judicial records respecting a divorce). However, these cases bear no resemblance to the instant cases.

In *Sendi v. Prudential-Bache Securities, supra*, the court issued a protective order in which the moving parties' tax returns were filed under seal, and any contents thereof, reflected in the pleadings or memoranda, were also sealed. The court recognized the special privacy and confidentiality interests accorded tax returns and balanced these interests against the need for discovery. See section 6103, respecting confidentiality of returns and return information. Here, petitioners have no special privacy or confidentiality interest that is protected by statute.[22] In fact, as public figures they may have given up many privacy rights.[23]

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[21] See *Estate of Gallo v. Commissioner*, T.C. Memo. 1985-363 n. 1, where, upon petitioners' request, we sealed numerous portions of the record consisting of sensitive financial information respecting an entity in a highly competitive industry.

The court in *In re Smith, supra*, ordered petitioner Smith's name to be permanently obliterated from records or pleas of guilty and sealed all pleadings, records, documents, and orders to protect Smith's reputation. The *Smith* case arose out of an investigation, by the U.S. attorney's office in Dallas, Texas, of bribery allegations concerning the Army and Air Force Exchange Service (AAFES). Mr. Smith was the head of AAFES. The investigation resulted in more than 25 convictions (none of which involved Smith) involving AAFES employees, Government contractors, and military sales representatives. Two of the Government contractors waived indictment and entered guilty pleas in *United States of America v. Churchill Sales Co.*, Criminal No. CR 3–80–165 (N.D. Tex., Aug. 1, 1980); and *United States of America v. Martin Taylor Co.*, Criminal No. 3–80–198 (N.D. Tex., Sept. 4, 1980). At the *Churchill Sales* and *Martin Taylor* plea hearings, despite the fact no evidence or testimony existed to support her statement, the assistant U.S. attorney read in open court, and filed in the above criminal cases, factual résumés which named Smith as a recipient of payments. After each of the plea hearings in the District Court, the media covering the AAFES bribery scandal reported that Mr. Smith had been paid bribe moneys by various businesses dealing with AAFES.

Following several months of adverse publicity, Smith filed motions in both the above-mentioned criminal cases asking the District Courts to either strike any mention of his name from the résumés and records or to seal the record. These motions were denied. Shortly after these rulings, Mr. Smith notified the personnel division of his intention to retire. Upon retirement, Smith was to receive his normal retirement pay commensurate with his employment grade plus an additional retirement annuity because of his participation in the executive management program (EMP). Approval for his retirement was soon acknowledged. Smith's attorney then filed a petition in the Circuit Court of Appeals for the Fifth Circuit seeking a writ of mandamus to compel the District Court to grant the relief requested in the motions. On the same day the writ of mandamus was filed, the Commander of AAFES issued notice to Smith that he was being suspended from the EMP. The only reasons given for the suspension were that Smith had been accused of wrongdoing in the two factual résumés previously discussed. After several months of AAFES administrative actions, amended and additional motions, and several orders entered by the administrative panel of the Circuit Court, the status of Smith remained essentially as it was on the day he retired, he had been retired with his regular retirement but his EMP benefits were being held in abeyance pending further AAFES proceedings. Thus, Smith showed that he suffered actual financial injury. The Court of Appeals granted the petition for writ of mandamus and noted at page 1107—

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[22] Sec. 6103(h)(4)(A) specifically authorizes the disclosure of return information in judicial tax proceedings.

[23] See, e.g., *Ann-Margret v. High Soc. Magazine, Inc.*, 498 F. Supp. 401, 405 (S.D.N.Y. 1980), where the court quoting *Goelet v. Confidential, Inc.*, 5 A.D.2d 226, 171 N.Y.S.2d 223, 225 (1st Dept. 1958), stated "Once a person has sought publicity he cannot at his whim withdraw the events of his life from public scrutiny." See also *Gertz v. Welch*, 418 U.S. 323, 344–345 (1974), where the court noted that public figures make their private lives and affairs matters of public business; *Man v. Warner Bros. Inc.*, 317 F. Supp. 50, 53 (S.D.N.Y. 1970), where the court quoting Hofstadter, Development of the Right of Privacy in New York, said "Those seeking notoriety will be said to have waived, and those having it thrust upon them to have lost, their right to personal seclusion."

> The presumption of innocence, to which every criminal defendant is entitled, was forgotten by the Assistant United States Attorney in drafting and reading aloud in open court the factual resumes which implicated [Smith] in criminal conduct without affording him a forum for vindication.
>
> Accordingly, we find the inclusion of Mr. Smith's name in the factual resumes were [sic] a violation of his liberty and property rights guaranteed by the Constitution and hold that [Smith's] motions to strike and seal should have been granted in the proceedings below.

In re Smith, supra, is distinguishable from the instant cases in that it arose out of a criminal case in which Smith was not a party and therefore was not able to testify on his behalf or given an opportunity to rebut the charges. In fact, Smith was not indicted on any bribery charge and the accusations made by the assistant U.S. attorney were totally unwarranted and without support. What is of significance here is that Smith *demonstrated* he suffered actual financial injury subsequent to the denial of his motions and that he had been subject to adverse publicity. Petitioners have totally failed to make such a showing.[24]

Furthermore, petitioners have not demonstrated any harm (financial or otherwise) that they have suffered or will suffer if their motions are denied; their contentions are wholly unsupported by the record. Petitioners are correct when they argue that Rule 103(a) permits this Court, in its discretion, to seal its records including pleadings to protect a party from embarrassment or harassment.[25] Nevertheless, merely asserting annoyance and embarrassment is wholly insufficient to demonstrate good cause.

We have carefully studied the thirty-seven newspaper articles submitted on petitioners' behalf at the hearing.[26] All of them were published in Texas newspapers in February 1985: twelve of the articles were published on February 6, twenty-two on February 7, two on February 8 and one on February 9.[27] None of them, in our opinion, even remotely suggest that petitioners are subject to criminal prosecution, albeit thirty-one of the articles report that Willie Nelson has been accused of *civil tax fraud*. Twenty-six articles report that petitioners' counsel, who is one of petitioners' counsel in these cases, was contacted and his replies were to the effect that it is believed the IRS position is grossly exaggerated, petitioner is certainly not guilty of any fraud, we expect to prevail in the litigation, or since the matter is in the courts we will let it be resolved there.[28] On the whole, we think the articles gave a factual report on petitioners' tax situation and, in fact, emphasized petitioners' claims that all of the deficiencies and additions to tax are in controversy and that no part of any underpayment is due to fraud.

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[24] In fact, petitioners have not been subject to adverse publicity and are in an enviable position whereby, they can utilize the media for their benefit by simply issuing a news release or calling a press conference.

[25] See generally *Seattle Times Co. v. Rhinehart*, 467 U.S. 20 (1984) (motion for protective order granted upon a showing that constituted *good cause* involving a religious foundation, its members, clients, and donors); *Parsons v. General Motors Corp.*, 85 F.R.D. 724 (N.D. Ga. 1980) (motion for protective order to have portion of pleadings filed under seal denied because *good cause* not shown); *Grinnell Corp. v. Hackett*, 70 F.R.D. 326, 334 (D.R.I. 1976) (where magistrate's order issuing protective order to shield deponents from annoyance, embarrassment, and oppression was vacated because "A showing that the likelihood of harrassment is 'more probable than not' is in [the court's] view insufficient" to warrant the issuance of a protective order); *Zwack v. Kraus Bros. & Co.*, 237 F.2d 255 (2d Cir. 1956) (where protective order granted regarding information that would have jeopardized the life of another).

[26] These articles were received in evidence.

[27] As recited earlier, the petitions were filed on Jan. 15, 1985.

[28] It appears that the majority of these articles were published *after* this contact with petitioners' counsel.

Petitioners further claim that the publications they submitted have caused the public to question Willie Nelson's availability for performances in light of "potential criminal prosecution." Petitioners did not show one instance where this happened. In fact, since the filing of the petitions, Willie Nelson has performed at the Merriweather Post Pavillion in Maryland; appeared in Plains, Georgia, to help former President and Mrs. Carter celebrate Plains' 100th Birthday; performed at his annual July 4 picnic in Austin, Texas; and performed 5 nights at New York City's Radio City Music Hall. On *May 6, 1985*, Willie Nelson won the Academy of Country Music's single record of the year award for "To All The Girls I Loved Before," which he sang with Julio Iglesias. If anything, in our view, Willie Nelson's popularity and desirability as a performer has remained intact, if not, increased.[29]

We think a few final observations are in order. Attached to each petition is a full copy of the statutory notice of deficiency, which lists all of respondent's determinations. The petitions on file contest all of those determinations and in the appropriate portions thereof "facts" are alleged.[30] Respondent, *in his yet to be filed answers*, must set forth facts to sustain his determinations under section 6653(b), the burden of proof for which is placed upon him. Sec. 7454(a) and Rules 36(b) and 142(b).[31] Thereafter, petitioners may file replies controverting respondent's answers wherein they shall set forth "a clear and concise statement of every ground, together with the facts in support thereof, on which the petitioner relies affirmatively or in avoidance of any matter in the answer on which the Commissioner has the burden of proof." See Rule 37(b). Moreover, trials before this Court "shall be conducted in accordance with such rules of practice and procedure * * * as the Tax Court may prescribe and in accordance with the rules of evidence applicable in trials without a jury in the U.S.

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[29] Another indication of Willie Nelson's continuing popularity is that from March through June of 1985 he had a song in the top twenty country and western singles based upon sales and broadcasts as reported in Billboard Magazine's publications for those months.

[30] In our judgment, those "facts" are nothing more than conclusions. See Rule 34(b)(5).

[31] Hence, petitioners' exhortations that they will be injured on the basis of unproven allegations in the answer are premature.

District Court of the District of Columbia."[32] See sec. 7453 and Rule 143(a).

On these records, after exhaustive analysis and research, we find and hold that petitioners have demonstrated no probative evidence of good cause sufficient to outweigh the public interests. The possibility that petitioners' status as nationally known entertainers may cause these cases to gain some notoriety is not a compelling enough reason to seal these records up to the time of trial. See *U.S. v. Hooker Chemicals & Plastics Corp.*, 90 F.R.D. 421, 426 (W.D.N.Y. 1981). Since good cause has not been demonstrated, petitioners' motions will be denied.

To reflect the foregoing,

Appropriate orders will be issued.

JOHN J. DEVENNEY, JR., AND SHIRLEY D. DEVENNEY, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 33417-83. Filed December 12, 1985.

Held: Respondent's litigating position was not unreasonable where the existence of a cash hoard was explained through the testimony of witnesses who were made known to respondent 2 weeks prior to the calendar call. Therefore, petitioners' motion for recovery of litigation costs is due to be denied.

Jo Karen Parr and *Richard L. Pyper*, for the petitioners.
Frank Simmons, for the respondent.

OPINION

WHITAKER, *Judge*: This case is before the Court on petitioners' motion for recovery of litigation costs filed on May 28, 1985, pursuant to Rule 231[1] and section 7430. The issues for decision are:

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[32] We mention this to emphasize that the concern for an "impartial jury" is not a legitimate concern in Tax Court proceedings. Cf. *Belo Broadcasting Corp. v. Clark*, 654 F.2d 423 (5th Cir. 1981).

[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as

(1) Whether petitioners qualify as a "prevailing party" and, if so,

(2) Whether petitioners have exhausted the administrative remedies available to them within the Internal Revenue Service.

Respondent determined deficiencies in petitioners' Federal income tax together with additions to tax under section 6653(b) for the years and in the amounts indicated:

Year	*Deficiency*	*Addition to tax sec. 6653(b)*
1977	$5,809	$2,905
1978	32,166	16,083
1979	24,244	12,122

This case was tried in November 1984 in Birmingham, Alabama. Following trial, findings of fact and opinion were stated orally pursuant to Rule 152. In that opinion, we found no deficiencies and, consequently, no additions to tax for any of the years. A decision to this effect was entered on April 30, 1985.

As a result of petitioners' motion, this Court vacated its decision of April 30, 1985, under Rule 162,[2] and ordered that respondent file a response to petitioners' motion for recovery of litigation costs. Subsequently, petitioners' and respondent's counsel were ordered to present to the Court a joint statement as to the facts with respect to the exhaustion of administrative remedies.

Pursuant to section 7430, the "prevailing party" in any civil proceeding brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under the Internal Revenue Code may be awarded a judgment for reasonable litigation costs incurred in such proceeding. To be eligible for an award of litigation costs, petitioners must meet two requirements: (1) They must satisfy

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amended and in effect during the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

[2] Sec. 7430(e) provides that an order granting or denying an award for reasonable litigation costs shall be incorporated as part of the decision and shall be subject to appeal in the same manner as the decision.

the statutory definition of a "prevailing party"[3] and (2) they must exhaust all administrative remedies available to them.[4] Respondent has conceded that, in the event we determine petitioners to be entitled to litigation costs, the amount of costs claimed by petitioners is reasonable.[5]

To satisfy the statutory definition of a "prevailing party," petitioners must (1) substantially prevail with respect to the amount in controversy or with respect to the most significant issue or set of issues presented, and (2) establish that the position of the United States in the civil proceeding was unreasonable.[6] Respondent has conceded that petitioners substantially prevailed with respect to the amount in controversy.

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[3] Sec. 7430(c)(2).

(2) Prevailing party.—

(A) In general.—The term "prevailing party" means any party to any proceeding described in subsection (a) (other than the United States or any creditor of the taxpayer involved) which—

(i) establishes that the position of the United States in the civil proceeding was unreasonable, and

(ii)(I) has substantially prevailed with respect to the amount in controversy, or

(II) has substantially prevailed with respect to the most significant issue or set of issues presented.

[4] Sec. 7430(b)(2).

(2) Requirement that administrative remedies be exhausted.—A judgment for reasonable litigation costs shall not be awarded under subsection (a) unless the court determines that the prevailing party has exhausted the administrative remedies available to such party within the Internal Revenue Service.

[5] Reasonable litigation costs are defined in sec. 7430(c)(1) as follows:

(1) Reasonable Litigation Costs.—

(A) In general.—The term "reasonable litigation costs" includes—

(i) reasonable court costs,

(ii) the reasonable expenses of expert witnesses in connection with the civil proceeding,

(iii) the reasonable cost of any study, analysis, engineering report, test, or project which is found by the court to be necessary for the preparation of the party's case, and

(iv) reasonable fees paid or incurred for the services of attorneys in connection with the civil proceeding.

In petitioners' motion for recovery of litigation costs, the expenses incurred were set forth as follows:

Attorneys' fees	$33,966.00
Accountant's fees for consultation and court appearance	2,145.00
Tax Court filing fee	60.00
Travel	275.00
Photocopies	136.68
Long distance telephone charges	61.77
Photographs	63.90
	36,708.35

Sec. 7430(b)(1) places a limitation of $25,000 on the amount of litigation costs which may be awarded with respect to any prevailing party in any civil proceeding. Petitioners are seeking a judgment for the full $25,000.

[6] Sec. 7430(c)(2), *supra* at note 3.

Thus, petitioners' status as a prevailing party is contingent upon establishing that respondent's position was unreasonable.[7]

The term "unreasonable" is not defined in section 7430, but the legislative history of the Tax Equity and Fiscal Responsibility Act of 1982 suggests the following guidelines:

> The committee intends that the determination by the court on this issue is to be made on the basis of the facts and legal precedents relating to the case as revealed in the record. [H. Rept. 97–404, at 12 (1981).] [8]

In *Baker v. Commissioner*, 83 T.C. 822, 828 (1984), this Court considered the question of reasonableness for purposes of section 7430, and concluded that "the determination of reasonableness should be made based upon all the facts and circumstances surrounding the proceeding and the fact that the Government eventually loses the case should not be determinative." Thus, our determination as to whether respondent acted reasonably in this case turns upon the legal basis for respondent's position in light of the facts available to him at the time of trial. Respondent determined petitioners' proposed deficiency using the source and application of funds method (case expenditures method). Use of this method has been authorized by the Supreme Court (*United States v. Johnson*, 319 U.S. 503 (1943)), and petitioners have not contested the propriety of its use in this instance.

The cash expenditures method is based upon the assumption that the amount by which a taxpayer's cash expenditures during a taxable period exceed his known sources of income for that period is taxable income, unless the taxpayer can show his expenditures were made from some nontaxable source of funds. A proposed deficiency determined by use of the cash expenditures method is presumptively correct, and the burden of proof is upon the taxpayer to demonstrate otherwise. *Welch v. Helvering*, 290 U.S. 111 (1933); Rule 142(a); *Burgo v. Commissioner*, 69 T.C. 729, 743 (1978). To meet this burden, petitioners must prove either that someone else made the expenditures or that the funds used were obtained from nontaxable sources, e.g., loans, gifts, inheritances, or assets on hand at the beginning of the taxable period. See *Taglianetti v. United States*, 398 F.2d 558, 563 (1st Cir. 1968), affd. 394 U.S. 316 (1969).

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[7] Any determination as to whether a party is a prevailing party shall be made by agreement of the parties or by the Court. Sec. 7430(c)(2)(B).

[8] Though not relevant on our facts, the committee indicated that the following factors were to be considered:

> (1) Whether the government used the costs and expenses of litigation against its position to extract concessions from the taxpayer that were not justified under the circumstances of the case,
>
> (2) Whether the government pursued the litigation against the taxpayer for purposes of harassment or embarrassment, or out of political motivation * * *
>
> [H. Rept. 97–404, at 12 (1981).]

In *Holland v. United States*, 348 U.S. 121, 135–137 (1954), the Supreme Court sanctioned use of the net worth method of income reconstruction subject to certain safeguards. This method is substantially analogous to the cash expenditures method. The Supreme Court's safeguards may be summarized as follows:

> (1) Respondent must track down relevant leads which might show alternative sources of nontaxable income if such leads are reasonably susceptible to being checked, and
>
> (2) respondent must give proof of a likely source of taxable income.

Thus, the reasonableness of respondent's legal position turns upon his satisfaction of the safeguards enumerated above in light of the facts and circumstances known to him subsequent to the filing of the petition.

Petitioners' position during trial on the merits was based on a "cash hoard" which petitioner-wife had purportedly accumulated from gifts and earned income. At an appeals conference held on August 6, 1984, petitioners' counsel presented the cash hoard defense naming petitioner-wife's deceased aunt and parents as the source of approximately $80,000 if gifts over a period of 20 years. It was also argued that a portion of the cash hoard had been saved in prior years by petitioners from earned income sources on which they had paid Federal income taxes.

Petitioners assert that respondent's position in the Tax Court proceeding was unreasonable because respondent presented no evidence negating petitioners' position that the funds had been accumulated over many years from savings and gifts. We disagree. As discussed above, respondent's proposed deficiency is presumptively correct, and the fact that petitioners ultimately prevailed at trial does not establish respondent's position as being unreasonable. *Baker v. Commissioner, supra* at 828. The test imposed upon respondent by *Holland* is whether the Government has investigated leads furnished by the taxpayer which are reasonably susceptible of being checked and which might trace the income to a nontaxable source.

Petitioners prevailed on their cash hoard defense because of the testimony given by 23 witnesses at the trial. Respondent was notified by letter dated October 15, 1984—two weeks prior to the call of the calendar—of the names and addresses of 25 witnesses, in addition to petitioners and petitioner-wife's parents,[9] who would be called to testify at the trial of the case. On October 28, 1984, one day before the call of the calendar, petitioners' representative withdrew 8 of the witnesses previously named and added 2 additional witnesses. We quote here from the oral findings of fact and opinion:

> We must determine, therefore, whether the objective evidence should be given conclusive weight which raises essentially the question of the credibility of the testimony. This case is unusual in that there have been many witnesses unrelated to Petitioners and with no reason to fail to testify truthfully albeit in a light most favorable to Petitioners. The existence of the cash hoard and the fact that it was old money was confirmed by bank tellers who received large deposits of currency during the years before the Court. Friends of Petitioners have not only testified as to their frugal habits and as to the long hours of work, but as to bits and pieces of observations and confirmations which tend to corroborate Mrs. DeVenney's testimony. We find that the testimony—we find all the testimony worthy of acceptance and fully credible including the testimony of Petitioners and of Mr. and Mrs. Smith, even though we recognize that the circumstances are at best illogical and unusual.

We conclude that the Government satisfied its obligation to track down relevant leads since it had no leads as to this testimony, which was crucial to our decision in this case. Of the 29 witnesses whose names and addresses were provided to respondent 2 weeks before the call of the calendar, respondent had advance knowledge of only 6. Respondent had no advance knowledge of the 2 witnesses whose names and addresses were provided on the day before the call of the calendar.

It is unreasonable to expect respondent in the short period remaining before the calendar call to track down and interrogate the unrelated third parties named as witnesses. Having listened to, and been persuaded by, the testimony of these witnesses whose existence was effectively unknown to respondent, we hold that respondent's position was reasonable subsequent to the filing of the petition and until the testimony was actually received. Respondent cannot be expected to incorporate the testimony of unknown witnesses into his analysis of a case. Silence, followed by surprise testimony, was the strategy embarked upon by petitioners in this case. We do not think that this strategy materially benefited petitioners from the standpoint of our findings of fact. However, it did have the effect of making respondent's position reasonable until the testimony was received. A lead that is essentially unknown before trial cannot be followed. *United States v. Smith*, 611 F.2d 375 (6th Cir. 1979); *United States v. Hamilton*, 620 F.2d 712 (9th Cir. 1980). Also we cannot fail to note that the existence of a cash hoard is endlessly claimed by taxpayers to explain the existence of otherwise unexplained sources of funds. It is rare indeed that a taxpayer successfully proves this contention. Thus, petitioners knew or should have known that, on these facts, their claims of a cash hoard would be met with some suspicion.

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[9] Respondent knew that petitioners and petitioner-wife's parents would testify. Petitioners made no showing, however, that the details of their testimony were disclosed to respondent prior to trial.

The second prong of the *Holland* test requires the Service to provide evidence supporting the inference that the petitioners' cash expenditures were attributable to currently taxable income. Petitioners assert that respondent presented no evidence showing an underreporting of income from any of petitioners' three businesses, nor any evidence demonstrating the existence of unreported sources of taxable funds. In short, this argument fails for the reasons stated above. Petitioners withheld evidence in the form of witnesses and their testimony which was crucial to a determination that no alternative taxable source of income existed. The nature of petitioners' businesses, and their commitment to them, became apparent largely through the testimony of these witnesses during trial. In the absence of this highly credible testimony, the mere existence of three closely held businesses would not preclude the possibility of unreported income. Thus, respondent met his burden as of the time of trial and was reasonable in applying the cash expenditures method as he did.

We hold that petitioners are not a "prevailing party" as required under section 7430(c)(2) and disallow the award for litigation costs. Petitioners selected silence as their litigation strategy. They must accept its consequences. Thus, we do not reach petitioners' obligation to exhaust the administrative remedies available to them.

Based on the foregoing, petitioners' motion for recovery of litigation costs will be denied.

An appropriate order will be entered.

RALPH NEELY AND VIRGINIA G. NEELY, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 24184-81, 26934-82. Filed December 17, 1985.

Petitioners made deductible charitable contributions of African art objects to qualified organizations. They also claimed deductions for fees paid to their art consultant for services relating to their art collection. Office furniture was transferred to one petitioner after his company was merged into another and his employment was terminated. Legal expenses were incurred in a suit to compel disclosure of financial information brought against a closely held corporation by a minority shareholder. *Held*, respondent's determinations of fair market value for the donated art are sustained. *Held, further*, petitioners are liable for additions to tax under sec. 6653(a) I.R.C. 1954. *Held, further*, fees paid by petitioners to their art consultant are deductible in part under sec. 212(3). *Held, further*, the office furniture transferred was not a gift and its fair market value at the time of the transfer is taxable income to petitioners. *Held, further*: Legal fees incurred in connection with the stock related to the disposition of a capital asset. They are therefore not deductible, but must instead be included in the basis of the asset. *Held, further*: Amendment of respondent's answer to assert application of sec. 6621(d) is not prejudicial to petitioners and leave to amend is granted. Where multiple items of similar nature are part of a single charitable contribution, a valuation overstatement, for purposes of sec. 6621(d), is to be determined by comparing the aggregate value claimed by taxpayer with the aggregate amount determined to be the correct amount of such valuation. The rate of interest prescribed by sec. 6621(d) is applicable after Dec. 31, 1984.

Reid E. Robison and *Kenneth L. Buettner*, for the petitioners.

Juandell D. Glass, for the respondent.

OPINION

CLAPP, *Judge*: Respondent determined deficiencies in, and additions to, petitioners' Federal income tax as follows:

Docket No.	*Year*	*Deficiency*	*Sec. 6653(a)*[1] *addition to tax*
24184-81	1976	$182,606.00	$9,130
	1977	54,592.00	2,730
	1978	370,210.00	18,511
26934-82	1979	166,678.50	8,334
	1980	38,944.00	1,947

The issues for decision are: (1) The amount deductible for charitable contributions of African art to qualified organizations in all years in issue; (2) whether respondent properly assessed an addition to tax under section 6653(a) for negligence or intentional disregard of rules and regulations regarding petitioners' claimed values for the contributed art; (3) whether fees paid in 1977 and 1978 in connection with petitioners' art collection were properly deductible; (4) whether office furniture transferred to petitioner Ralph Neely (Neely) was taxable income or a nontaxable gift; (5) whether legal fees paid in 1977 and 1978 in relation to stock owned by petitioner Virginia Neely (Mrs. Neely) were properly deductible against ordinary income or should have been added to basis; and (6) whether respondent's motion to amend his answers should be granted, and if so, whether the imposition of section 6621(d) increased interest raised in the amendments is appropriate. For convenience, our findings of fact and opinion are combined.

Some of the facts, and the exhibits pertaining thereto, are stipulated and are so found. Petitioners Ralph Neely and Virginia G. Neely are husband and wife, who, at the time they filed their petition, resided in Reno, Nevada. They filed their tax returns for the years in issue with the Internal Revenue Service in Ogden, Utah.

Petitioner Ralph Neely graduated from the University of Texas with a bachelor of science degree in business in 1936 and later earned a graduate degree in business and investment management. He held several jobs while working his way through his undergraduate and graduate studies. One of these positions, which continued after graduation, was with the State of Texas Insurance Department. He later joined an insurance brokerage firm in Oklahoma City, Oklahoma. During World War II, Neely became an officer in the U.S. Naval Reserve and served 4 years of active duty. Subsequently, he reentered the insurance brokerage business. In 1959, he joined a business which later became the Doric Corp. (Doric). By 1973, he was president, chairman of the board of directors, and chief executive officer, which positions he held until 1976. In April 1975, Doric was merged into a subsidiary (Esmark) of Esmark, Inc. In 1976, Neely exercised an option in his employment agreement to become a consultant to the firm. That same year, the Doric offices in Oklahoma City were closed and its operations transferred to the Chicago headquarters of Esmark.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 effective for the tax year or years in issue.

Petitioner Virginia Neely graduated from Vassar College, and later continued her education by taking various art courses. Some of these were at the University of Oklahoma and were sponsored by the Oklahoma Art Museum. During World War II, Mrs. Neely worked with a steamship line in San Francisco, California, assisting in cargo and troop movements. She later returned to Oklahoma City, where she worked for a brief period as a medical lab technician. She has also been a housewife and is the mother of five children. Mrs. Neely has pursued her interest in art by studying ceramics of both Chinese and American origin, antique furniture of the French, English, and Early American styles, and oriental rugs. Through her pursuits she has acquired an interest in, and an aptitude for, interior design.

In addition to these other forms of art, Mrs. Neely also became attracted to African art. The term "African art" embraces sculpture crafted by native artisans and usually takes the form of masks or icons of the types used in tribal rituals. In 1968, Neely, aware of his wife's interest, gave her a Christmas present of a piece of African art which she had admired. Gradually, petitioners added pieces to their collection. Initial acquisitions were made from Ben Pickard (Pickard), a dealer in Oklahoma City. In 1972, petitioners made the acquaintance of Thomas L. McNemar (McNemar) while he was in Oklahoma City for the purpose of discussing African art with Pickard. By that time, petitioners had resolved to amass a very large personal collection of African art, and they purchased 118 pieces from McNemar in the period 1972 to 1974 for a total price of $161,267. McNemar sold the art to petitioners at his cost plus a 10- to 20-percent markup. Petitioners did not examine the art prior to the purchases.

Mrs. Neely, in 1973, formed Vaney, Ltd. (Vaney), an Oklahoma closely held corporation, of which she was the sole shareholder. Later that year, Vaney entered into a joint venture agreement with Ben Pickard, Inc., creating the partnership Pickard Art Galleries, Ltd. (PAG). The stated purpose of the partnership was to operate an art gallery. Ben Pickard was the original manager of the gallery. He purchased for the gallery substantial amounts of African art from McNemar. McNemar decided what pieces would be shipped to the gallery, and he determined the prices he would be paid for these items. Although Pickard did not negotiate the prices the gallery paid for the pieces, he had authority to accept or reject any of the shipments. In the course of purchasing more than 1,200 pieces from McNemar, Pickard made no rejections. PAG held a public auction in Dallas, Texas in June 1975, at which it offered more than 200 pieces of the African art. None of the items sold.

PAG, in financing its purchases of art, became primarily liable on promissory notes aggregating $250,000 to Liberty National Bank & Trust Co. of Oklahoma City (Liberty). Petitioners were guarantors on these notes. In addition to the guaranty, Liberty had obtained a security interest in the art and certain other assets of PAG. PAG defaulted on the debt and although the bank had a right to call upon the guaranty without first foreclosing upon the collateral, it elected to do the latter. Liberty chose to foreclose on the secured property (rather than call the quaranty) as a direct result of petitioners' agreement to bid a minimum of $260,000 for the property in bulk. The bank then took possession of the secured property, which consisted largely of African art, and on March 16, 1976, offered the property at a foreclosure auction. As of that date, the outstanding balance due Liberty, including interest and miscellaneous costs, was $255,761. The foreclosure sale was promoted by advertisement in the Wall Street Journal and in the principal newspapers in Dallas, Houston, and Los Angeles, these being considered by Liberty to be the major markets for the African art being sold. Nevertheless, petitioners' bid of $260,000 was the only bid. The amount of the bid allocable to the 1,202 pieces of African art included in the sale (other items were included in the bulk sale) is $246,909. Thus, by March 1976 petitioners owned approximately 1,300 pieces of African art, for which they had paid slightly more than $400,000.

McNemar was an acquaintance of Tom Seligman (Seligman), the curator at the M.H. de Young Memorial Museum (de Young) in San Francisco, California. Subsequent to the foreclosure auction in 1976, McNemar suggested that petitioners make a charitable contribution of some of the art to that museum. He did not suggest to petitioners, and they did not pursue, the possibility of selling any or all of the art. Mrs. Neely had lived in San Francisco and she considered de Young to be a fine museum. Petitioners donated 112[2] items of African art to de Young in December 1976. In March 1978, de Young sold all but four pieces at an auction gallery. The art was offered without reserve and the museum received a total of $26,075 on the sale. Two of the remaining four pieces were sold in 1983 for a total of $110. Petitioners were dismayed that the art was sold at auction, and decided to make no further donations to de Young.

McNemar had become acquainted with Adolphus Ealey (Ealey), the director of the Barnett-Aden Foundation Gallery in Washington, D.C. (Barnett-Aden) and brought it to the attention of petitioners as a potential donee. Barnett-Aden is a gallery which owns a large collection of Afro-American art. Most of the collection consists of paintings (Afro-American art), as opposed to primitive sculptures such as those donated by petitioners (African art). Ealey acquired the collection in 1971 and has housed it in his personal residence since then. The gallery functions as an archive, lends pieces to schools and museums, and coordinates exhibitions. The gallery owned approximately 12 pieces of African art prior to the 1977 donation by petitioners. It lends African art, only in conjunction with Afro-American art, for the purpose of explaining the association and transition in styling between the two. Petitioners donated 12 pieces of African art to Barnett-Aden in 1977.

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[2] There is conflict whether the number of pieces donated to de Young was 112 or 114; we accept petitioners' figure of 112.

Subsequent contributions of petitioners' African art were made to Duke University in Durham, North Carolina (Duke). Petitioners' son, while in attendance there, learned that the university's art museum had a minor collection of African art. McNemar contacted the director of the museum to inquire whether Duke might be interested in a contribution from petitioners' collection. An understanding was reached between petitioners and Duke which provided that petitioners would make a permanent loan of the pieces remaining in their African art collection, and that they would make substantial contributions of these pieces to Duke over a period of years. Petitioners donated to Duke 197 pieces in 1978, 96 pieces in 1979, and 25 pieces in 1980. Duke displayed 55 of the items from 1978 to 1981; 2 others were displayed during the first quarter of 1981. None of the other pieces, either lent or donated, has been displayed.

The contributions of African art made by petitioners during the years in issue are summarized as follows:

Calendar tax year	*Donee*	*Number of items*	*Claimed*[3]	*Cost*[4]	*Allowed*[5]
1976	de Young	112	$321,200	$43,106	$33,575
1977	Barnett-Aden	12	60,000	7,177	5,350
1978	Duke	197	683,975	29,278	75,055
1979	Duke	96	270,780	6,395	33,775
1980	Duke	25	167,150	5,770	20,100
		442	1,503,105	91,726	167,855

I. Valuation of Contributed African Art

Petitioners relied on McNemar for his advice and expertise regarding African art and consider him to be a competent and experienced individual in the field. He has acted as their African art consultant since 1972. McNemar lived in Africa for extended periods throughout the 1960's and early 1970's. He began to acquire art for resale in the mid-1960's and has sold the same from that time until the present. His activities have embraced the entire spectrum of the art product from "traditional" art[6] at the one end to "tourist" or "airport" art[7] at the other. Traditional art is substantially more valuable than tourist art. In his search for acquisitions, McNemar traveled into various geographic regions of west and equatorial Africa, making his purchases (usually with currency) in the country of origin. Because he is an outsider to African cultures, McNemar was able to witness very few tribal ceremonies in which the art was actually used. McNemar is not, and does not claim to be, an appraiser of African art or any other primitive art. He has obtained a familiarity with the subject through his own "diligent effort," but has no formal education in the area. McNemar handled the details of each of the donations, including arranging for, and assisting in, the appraisals of the art.

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[3] Amounts shown in this column are those claimed by petitioners on their Federal income tax returns for the respective years in issue as the fair market values of the items contributed.

[4] Amounts shown in this column are those reported by petitioners on their Federal income tax returns for the respective years in issue as their acquisition costs for the items contributed.

[5] Amounts shown in this column are those determined by respondent in his notices of deficiency dated June 26, 1981 (regarding calendar tax years 1976–78) and Aug. 26, 1982 (regarding calendar tax years 1979 and 1980) as the fair market values of the items contributed.

James W. Willis (Willis), a San Francisco dealer in primitive art, was engaged by McNemar to appraise the pieces composing the de Young donation. In late 1976, he placed a fair market value of $321,200 on them. Willis at that time appraised a total of 1,070 of the pieces belonging to petitioners at an aggregate fair market value of $2,181,310. Ten of the pieces which remained after the de Young donation were reappraised by Willis in late 1977 at a fair market value of $10,000. These, along with two others, which were appraised by William L. Hommel (Hommel) at a fair market value of $50,000, composed the 1977 donation to Barnett-Aden.

Willis graduated from Pamona College in 1957 with a degree in international relations and did work toward a master's degree in English literature at San Francisco State University until 1968. After that time, he was employed as a professional ceramicist. He describes his present occupation as "dealer in African Oceanic and Polynesian and Indonesian art in San Francisco, where [he] operate[s] a gallery." He first opened a modest gallery, occupying approximately a 10-foot square, in May 1972. In that same year, he made the first of his five trips to Africa. This journey was made for the purpose of purchasing art; his four subsequent trips, each approximately 3 to 4 weeks in duration, were made as an employee of a travel agency to accompany groups of collectors. He has held a number of continuing exhibits in his gallery, has attended auctions in New York, London, and Paris, and had appraised between 5 and 10 collections prior to his 1976 appraisal of petitioners' collection. Petitioners' collection was the first of its size appraised by him. Willis has had no formal education in the area of African art, but has done independent reading on the subject. He asserts that "the majority of [his] experience is in actually handling and considering pieces."

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[6] "Traditional" African art is that which is made by a native artist in his African habitat in conformance with the style of his cultural group, intended for use within that culture, and so used.

[7] "Tourist" or "airport" art is that which is specifically made to be sold to tourists and is usually produced in quantity in workshops established for that purpose.

Hommel was recommended by Ealey for the appraisal of the two items donated to Barnett-Aden which had not previously been valued by Willis. Hommel received his baccalaureate degree in 1963 and earned a master's degree in art history (with a concentration in African art) in 1977, while studying under professor Roy Sieber (Sieber) at Indiana University. He continued his studies with Sieber and received a doctoral degree in 1981. He has been a lecturer and consultant on the subject and performed numerous appraisals from 1975 until 1979, in which year he ceased doing appraisal work. Hommel, in the curriculum vitae contained in his expert report offered as evidence before this Court, overstated his academic credentials and experience in the area of African art.

In addition to the appraisal of the two pieces in 1977, Hommel compiled an appraisal report in May 1978 in which he valued all of the pieces remaining in the collection after the 1976 and 1977 donations. This resulted in a substantial overlap of his work with that of Willis. Of the approximately 900 pieces which were valued by both appraisers, not one was ascribed a value by Hommel which was less than or even equal to the value determined by Willis. There was considerable disparity on a preponderance of the valuations. Hommel's values ranged from 250 percent to over 1,600 percent of those of Willis' and averaged approximately 500 percent of the latter's values.

Hommel testifed that his assessment of value is predicated on the assumption that all of the pieces he appraised are traditional art and further indicated that his figures would be in error were such not the case. Hommel relied upon the statement of McNemar that all of the pieces are traditional art, and upon his examination of them, in performing his valuation. He has not waivered from his opinion that every piece he valued is traditional African art. Hommel defined traditional African art as "an object which was made for use for the culture that it was made."

The values determined by Hommel in his May 1978 report were used by petitioners on their tax return for the pieces donated to Duke in that year. In October 1979, he prepared another report wherein he reappraised the 96 items donated to Duke, and reported on petitioners' tax return, in that year. These items were uniformly valued at 125 percent of the values shown for the same items on the May 1978 report. The values reported on petitioners' 1980 tax return for the 25 items donated to Duke in that year correspond, without any adjustment, to those contained in the May 1978 report.

Before hiring Hommel, McNemar, in March 1978, provided him with photographs of pieces which had been donated to de Young and a checklist containing Willis' corresponding valuations. McNemar requested that Hommel return the materials with his (Hommel's) opinion of value so that McNemar could "know the price range in which [he could] expect [Hommel] to work." McNemar, in the same correspondence to Hommel, indicated that there was a well organized list of the art collection which would minimize the paperwork for the job. His letter further disclosed that the list also contained his (McNemar's) opinion of market value and that "The collection contains over 1,100 objects valued at $6,650,000." Approximately 1,000 of the items which Hommel appraised had been previously ascribed a value on that list by McNemar; over half of the values on Hommel's appraisal report were identical to those contained in McNemar's list.

Respondent's determination of the value of the pieces donated in 1977–80 is based largely upon the appraisals of Irwin Hersey (Hersey). Hersey is the only expert offered by either party, who is a full-time appraiser. Although he has no formal education in the area, Hersey has been a collector of African art for more than three decades and has performed numerous appraisal, authentication, cataloging, and consulting services since 1967. Hersey is a senior member of the American Society of Appraisers; the head of the primitive arts section of the International Society of Appraisers; a member of the American Association of Appraisers; and a member of the Union Francaise des Experts, with a specialty in primitive art. He has been a consultant to major museums and private collectors and has served as an adviser to the Museum of African Art in Washington, D.C.

Respondent also obtained a valuation report from Sieber regarding the 1979 and 1980 donations to Duke. Sieber has taught the subject of African Art since the early 1950's; has been a professor at Indiana University since the early 1960's (where he earned a named professorship in fine arts in 1974); has authored manifold works on the subject; has made a number of trips to Africa for the purpose of research; has taught at African universities; and has served as consultant to a variety of museums. He is currently the Associate Director for Collections and Research for the Museum of African Art at the Smithsonian Institution, a position which he holds concurrently with his professorship at Indiana. Petitioners recognize Sieber as a leading American Africanist and African art historian.

Hommel was the only expert to opine that all of the donated pieces are traditional African art. Petitioners' own expert, Willis, in addition to respondent's experts, determined that many of the items are not traditional. Hersey and Sieber each determined that nearly 80 percent of the art is not traditional. We find that most of the donated art is not traditional.

The parties have stipulated that the donee institutions (de Young, Barnett-Aden, and Duke) are, and were at the time of the respective contributions, entities described in sections 170(c) and 501(c), donations to which will qualify as deductible charitable contributions.

Respondent raises, for the first time on brief, the proposition that petitioners' deductions for the charitable contributions of their art be limited to their cost basis in the art. This is founded on the alternative arguments that either petitioners were dealers in African art by virtue of the activities of Vaney, or were engaged in activities substantially equivalent to those of a dealer because of the frequency and continuity of their contributions. Because this issue was not raised in the deficiency notice or the pleadings, it was raised untimely and caused surprise and prejudice to petitioners. We therefore will not consider it.

> Any doubts we may have with regard to petitioner's surprise must be dismissed when we consider the potential abuses which could occur by the use of "informal" means of communicating new theories which are not inherent in respondent's original determination. If respondent desired this theory to be before the Court, he could have amended his pleadings to clearly inform the petitioner and the Court of his intended lines of attack. [*Estate of Horvath v. Commissioner*, 59 T.C. 551, 556 (1973).]

See generally *Seligman v. Commissioner*, 84 T.C. 191 (1985), and cases cited therein.

The amount deductible for the gifts is the fair market value of the property at the time of contribution. Sec. 1.170A-1(c)(1), Income Tax Regs.[8] Fair market value is the price at which property would change hands between a willing buyer and a willing seller, neither being under compulsion to buy or sell and each having reasonable knowledge of relevant facts. Sec. 1.170A-1(c)(2), Income Tax Regs.

Respondent's determination of deficiency is presumptively correct and petitioners bear the burden of proof to the contrary. Rule 142(a);[9] *Welch v. Helvering*, 290 U.S. 111 (1933). We have previously said with regard to the issue of market value that—

> each of the parties should keep in mind that, in the final analysis, the Court may find the evidence of valuation by one of the parties sufficiently more convincing than that of the other party, so that the final result will produce a significant financial defeat for one or the other, rather than a middle-of-the-road compromise * * * [*Buffalo Tool & Die Mfg. Co. v. Commissioner*, 74 T.C. 441, 452 (1980).]

Such a situation is now before us. Petitioners have failed to persuade the Court that respondent's determinations of value are in error. Quite to the contrary, we find that the estimates of value adopted by petitioners are exaggerated and we accordingly reject them.

The valuations determined by Hommel are at best unreliable. He was ostensibly hired to appraise approximately 300 pieces which had not been valued by Willis. Hommel in fact appraised all of the pieces remaining after the 1976 and 1977 donations, about 1,200 in number, even though the bulk of these had already been appraised by Willis. Prior to hiring Hommel, McNemar required that he provide an example of the "price range" in which he could be expected to work. According to McNemar, this was so petitioners could ascertain that Hommel would provide values which were not immoderate. However, Hommel's figures for pieces which had been previously appraised by Willis are from 250 to 1,600 percent of Willis' values. Hommel's values for the 1978-80 donations are, on average, approximately 800 to 900 percent of those determined by respondent's experts. It seems that instead of seeking a middle-of-the-road appraiser, petitioners had quite different intentions. Despite the protestations of petitioners and McNemar to the contrary, it appears to us that McNemar "shopped" for an appraiser who could provide values in the right "price range"—a range of values much higher than that provided by Willis—and engaged Hommel for the job.

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[8] Unless otherwise indicated, all regulation section references are to the Federal Income Tax Regulations (Title 26, Code of Federal Regulations) effective for the tax year or years in issue.

[9] Unless otherwise indicated, all Rule references are to the Tax Court Rules of Practice and Procedure.

Additionally perplexing is the fact that approximately 1,000 of the items valued in Hommel's May 1978 appraisal report had previously (in February 1978) been assigned values by McNemar, and Hommel's values for more than one half of these items are identical to McNemar's. Portions of McNemar's list and Hommel's May 1978 appraisal report are reproduced in the appendices. Petitioners offer, as an explanation for this conspicuous improbability, that McNemar prepared his own estimate of value for the purpose of obtaining transit insurance on the 1978 shipment to Duke; that this was necessary because of Neely's insistence upon swift shipment of the items and the slow rate of progress on the then-uncompleted Hommel appraisal; and that McNemar replaced the valuation entries he had made on his list with those of Hommel, obtained by telephone, as Hommel proceeded with his appraisal.

We find this unpersuasive. Hommel had begun work on his appraisal report, dated May 27, 1978, approximately 6 weeks prior to that time. Considering that petitioners did not ship the art to Duke until mid-August of that year, it appears that immediacy was not as paramount a concern as petitioners would have us believe. We consider it significant that petitioners offered only the testimonial evidence of McNemar regarding these purported revisions and have failed to introduce the real evidence in question, i.e., McNemar's original list, which could readily demonstrate whether such changes had in fact been made. The copy of that list which is in evidence, Exhibit 11-K, is a second or third generation photocopy. We find that Hommel adopted as his own the value figures provided him by McNemar and incorporated them into his appraisal report.

Finally, Hommel based his estimates of value on the erroneous assumption that every piece he appraised was traditional African art. Hommel freely admitted that if any of the pieces were not traditional, his valuation would be wrong. The other expert witnesses differed in their opinions regarding the proportion of the art which is traditional, but there was agreement among all of them, including petitioners' witness Willis, that not all of the art is traditional. Hersey and Sieber each determined that approximately four of every five pieces they examined are not traditional. Hommel's definition of traditional African art is deficient, most conspicuously for its failure to include the actual use of the item within the cultural group as an element. Each of the other experts (including petitioners' expert, Willis) included actual use of the art as an essential element in defining traditional African art. We have found that most of the donated art is not traditional. Because of the questionable circumstances surrounding Hommel's appraisals, and because his values are predicated upon the fallacious assumption that all of the art is traditional, we reject the valuations determined by him.

We have said that although we will not reject expert evidence without objective reasons for doing so, one such reason is that the evidence provided by another expert is more persuasive.[10] Willis began as a dealer in primitive art in 1972 when he opened what he characterized as a modest gallery which occupied only a 10-foot square. He is not affiliated with any organization of appraisers, and had done only 5 to 10 appraisals at the time of his 1976 appraisal for petitioners. Willis testified that he valued the art at prices at which he felt his gallery could sell it. We find it significant that Willis was aware of the de Young auction of the art donated by petitioners and even had someone purchase 2 of the pieces at the auction for him. It is most inconsistent that a dealer in such art, when presented with the opportunity to purchase more than 100 pieces at less that 10 percent of the price at which he felt he could resell them, would purchase only 2.

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[10] *Estate of Gallo v. Commissioner*, T.C. Memo. 1985-363, citing *Buffalo Tool & Die Manufacturing Co. v. Commissioner*, 74 T.C. 441, 452 (1980).

We find that the qualifications, background, training, experience, and methodology of respondent's expert Hersey are more compelling than those of Wiliis. Sieber, although not actively involved in appraisal work, is a leading Africanist and is eminently qualified to distinguish African art which is traditional from that which is not. This fundamental question is crucial to the valuation of the art, since traditional art will command a significantly higher market value than nontraditional (tourist or airport) art. Sieber's valuation report corroborates the valuations determined by Hersey.

For the reasons outlined above, we are persuaded that the valuations determined by respondent in the deficiency notices are not in error. Accordingly, with regard to this issue, we hold for respondent, and find that the amounts deductible are: $33,575 in 1976, $5,350 in 1977, $75,055 in 1978, $33,775 in 1979, and $20,100 in 1980.

II. Addition to Tax

Section 6653(a)[11] provides that where any part of an underpayment of income tax is due to negligence or intentional disregard of rules and regulations, an amount equal to 5 percent of the underpayment shall be added to the tax. Broadly speaking, for the purposes of this section, "Negligence is lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances." *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967). Just as with respondent's determination of deficiency, his determination of negligence or intentional disregard of rules and regulations is prima facie correct with the burden of proof to the contrary on petitioners. *Bixby v. Commissioner*, 58 T.C. 757 (1972). Thus, petitioners must show that they acted reasonably and prudently and exercised due care in obtaining the appraisals of fair market value which they used on their tax returns. Regulation section 1.170A-1(c)(1) provides, in general, that a charitable contribution of property other than money is deductible at the fair market value of that property as of the time of the contribution. Fair market value, discussed above, is defined in section 1.170-1(c)(2), Income Tax Regs.

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[11] Sec. 6653(a) provides as follows:

SEC. 6653. FAILURE TO PAY TAX.

(a) Negligence or Intentional Disregard of Rules and Regulations With Respect to Income or Gift Taxes.—If any part of any underpayment (as defined in subsection (c)(1)) of any tax imposed by subtitle A or by chapter 12 of subtitle B (relating to income taxes and gift taxes) is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 percent of the underpayment.

An ordinarily prudent person in the position of petitioners should reasonably have known that the appraisals obtained from Willis and Hommel were in substantial variance with the actual fair market value of the art. Willis' appraisal, upon which petitioners relied for the values claimed in their 1976 and 1977 returns, valued the items donated at an average of approximately 750 percent of acquisition cost in 1976 and 850 percent of cost in 1977. McNemar, from whom the art was acquired, was a dealer in such art at the time he sold it to petitioners or to PAG, and there is no evidence to support a conclusion that he was motivated by other than a profit motive. Petitioners' own evidence indicates that the sales were made at a 10- to 20-percent markup over McNemar's cost.

To reconcile this chasm between petitioners' cost and Willis' market value, we are asked to accept the proffered explanation that McNemar was willing to sell the art to petitioners at a price near his cost (foregoing the remarkable profits he could reap if he were to sell at Willis' estimate of market value) because he feared losing his investment altogether should the export of traditional African art be banned. The ban, according to McNemar's own testimony, was not to be implemented until after 1974. It is stipulated, however, that McNemar's sales to petitioners spanned a period of more than 2 years during 1972–74 and involved at least eight transactions. This course of dealing can hardly be characterized as duress or compulsion to sell. Indeed, McNemar characterized himself as a willing seller and petitioners as willing buyers in the transactions. Surely McNemar could have found a buyer willing to pay more than 10 or 20 percent above his cost if the fair market value were indeed some 800 percent above his cost.

This disparity alone was sufficient cause for a reasonable and prudent person to call into question the valuations determined by Willis, but it did not stand alone. Petitioners were aware of the difficulties of the gallery, PAG, which foundered due to poor sales and ultimately failed. The results of the foreclosure auction by Liberty and the unsuccessful Dallas auction by PAG indicated that the market value for petitioners' art was well below the values they claimed on their returns. The fact that de Young auctioned the great bulk of petitioners' 1976 donation without reserve, receiving under $27,000 for art which Willis had valued at over $300,000 was additional reason to question the validity of his appraisal figures.

Heedless of these signals, or perhaps despite them, petitioners had McNemar seek another appraiser allegedly for the limited purpose of appraising the approximately 300 pieces which Willis had not appraised. After Hommel provided "a sample of 'the range' in which [he could] be expect[ed] to work," he was engaged to reappraise all the remaining art, which numbered approximately 1,200 pieces, including approximately 900 pieces which had already been valued by Willis. Petitioners' explanation for this duplication of effort is that Willis was too busy to complete his work by appraising the remaining 300 pieces; that these pieces had somehow become "hopelessly intermingled" with the rest of the collection; and that because McNemar did not have the paperwork on hand to determine which of the numbered pieces had not been appraised, it was decided that Hommel would appraise the entire collection. Hommel's valuation figures ranged from approximately 250 percent to 1600 percent of Willis' figures, and averaged approximately 500 percent of the latter's values. Hommel's values average more than 900 percent of those determined by respondent for the 1978 donation and more than 800 percent of respondent's values for each of the 1979 and 1980 gifts. The explanation offered to reconcile the marked disparity between the values determined by Willis and Hommel is that Willis was a West Coast dealer and was not exposed to "East Coast prices" at his gallery; that Hommel used comparable sales made at these "East Coast prices" in his appraisal; and that there was a "rapid expansion" in African art prices between Willis' December 1976 appraisal and that of Hommel in May 1978.

The explanations offered by petitioners have failed to persuade us that respondent's determination of the addition to petitioners' tax is in error. We believe that a reasonable and prudent person in the position of petitioners would recognize the inconsistency between the appraisals obtained by petitioners and the contrary evidence of value displayed in the aforementioned circumstances, and undertake additional inquiry accordingly. Petitioners have failed to show exercise of due care. To the contrary, their actions, in seeking another appraiser who could provide values in a range more to their liking, point to intentional disregard of rules and regulations. Accordingly, with regard to this issue, we hold for respondent.

III. Appraisal Related Expenses

Petitioners paid McNemar $25,000 for his assistance in cataloging their African art collection, negotiating the charitable contribution to de Young, and preparing the items for the 1976 appraisal. He was paid $13,600 in 1977 and $11,400 in 1978. Petitioners claimed these amounts on their returns for the respective years as "section 212 expenses relating to art appraisal fees required for the determination of taxable income."[12] Respondent disallowed these deductions for the reason that petitioners had not established that the expenses were either ordinary and necessary business expenses, or that they were expended for the purpose designated. Petitioners make no contention that the expenses were business expenses.

Respondent does not dispute that appraisal fees which are paid to determine the fair market value of property which is part of a charitable contribution are deductible under section 212(3)[13]. It is stipulated that the fees were paid to McNemar for cataloging the collection, negotiating the donation with de Young, and preparing items for the 1976 appraisal by Willis. Of these services, only the negotiations with de Young related solely to the charitable contribution. The catalogue prepared by McNemar embraced the entire collection, which consisted of well over 1,000 pieces, while the de Young donation contained only 112 pieces. Likewise, more than 1,000 items were appraised by Willis in 1976, and McNemar's services extended to all of these, not just the pieces given to de Young.

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[12] Sec. 212 provides as follows:

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or

(3) in connection with the determination, collection, or refund of any tax.

[13] Rev. Rul. 67-461, 1967-2 C.B. 125.

With regard to the portions of the fees expended in relation to McNemar's efforts in cataloging the collection, we find that these are not deductible under section 212(3). Some part of McNemar's work in cataloging the collection might have facilitated Willis' appraisal, but we find that the project was not commenced, or used, for that purpose. McNemar's own testimony reveals that he and Willis worked on the 1976 appraisal from a listing of the art which had been prepared by neither of them.

The portions of McNemar's fees which relate to his assistance in the 1976 appraisal of items given to de Young and negotiating the donation to de Young come within section 212(3), and are deductible pro tanto. Although petitioners have shown that some part of the amount claimed was properly deducted, they have offered scant evidence from which a proper determination of that amount can be made. See *Lightsey v. Commissioner*, 63 F.2d 254 (4th Cir. 1933), affg. a Memorandum Opinion of the Board of Tax Appeals.

We find that $4,600 of the $25,000 total fee paid to McNemar was properly deductible, $2,502 of this amount in 1977 and $2,098 in 1978. Any inexactitude is of petitioners' own making. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

IV. Office Furniture

When the Doric offices in Oklahoma City were closed, it was decided that the furniture which had been used by Neely at that location would be transferred to him. The book value of the furniture was $11,856 at the time of its transfer to Neely in 1976. Neely did not receive a Form W-2 or Form 1099 reporting the value of the furniture as compensation to him.

A two-page memorandum, authored by the controller of Doric, Doug Polacek (Polacek) and dated August 3, 1976, discussed the transfer of the furniture. The pertinent portion of the memo is as follows:

> Jim, these are the arrangements for the closing of the Doric office and the handling of the Doric personnel as agreed to by Joe Sullivan and Roger Briggs.

Ralph Neely

> His office in Oklahoma City will be continued at Doric's expense until the end of 1976. He is given his furniture which at this time has a net book value of $12,723 (see attachment 1). He also receives (started on April 1, 1976) $4,275 a month for 40 months and $2,500 a month for 120 months. These payments were reserved for on a discounted basis at the time of acquisition (attachment 2 gives a breakdown of expense by year for these payments).

On the second page of the memo, the value of the furniture transferred to Neely is included as one of the estimated expenses for the closing of Doric's offices, along with expenses for employees' severance pay and office moving expenses. Neely testified that he and the president of Doric each received the furniture in their offices and that other furniture was appraised and distributed to the employees of the office. Respondent determined that the transfer of the furniture was not a gift, that the fair market value of the furniture was $11,856, and that petitioner's taxable income for 1976 should be increased by that amount.

Petitioners correctly assert that the most critical consideration in determining whether a transfer is a gift for Federal income tax purposes is the transferor's intention. *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960), citing *Bogardus v. Commissioner*, 302 U.S. 34, 43 (1937). *Bogardus* "makes it plain that the donor's characterization of his action is not determinative—that there must be an objective inquiry as to whether what is called a gift amounts to it in reality." *Commissioner v. Duberstein, supra* at 286, citing *Bogardus v. Commissioner, supra* at 40. Determination as to whether a transfer amounts to a gift must be reached on consideration of all the factors, and the proper criterion is the basic reason for the transferors conduct—"the dominant reason that explains his action in making the transfer." *Commissioner v. Duberstein, supra* at 286. A gift for Federal income tax purposes proceeds from a "detached and disinterested generosity." *Commissioner v. LoBue*, 351 U.S. 243, 246 (1956).

Petitioners argue that because Ralph Neely never received a Form W-2 or Form 1099 regarding the furniture, it is therefore undisputed that Esmark treated the furniture as a gift. We disagree. The nonreceipt of such a form is far from determinative.

The Polacek memo is similarly inconclusive. The only evidence it offers is the clause, "He is given his furniture." But, as noted above, a donor's characterization of his action is not determinative. Furthermore, it is not clear that the language quoted from the memo was intended to characterize the transfer as a gift at all. The sentence following it discusses "consulting fees" which were to be paid to Neely for a period after termination and which were undisputedly taxable income. It could be inferred from the language of the memo that Polacek considered the payment of the "consulting fees" and the "gift" of the furniture to be similar elements in Neely's termination arrangement.

Neely's testimony regarding the circumstances surrounding the "gift" is also unpersuasive. Accordingly, we find that the value of the furniture transferred to Neely must be included by petitioners as income.

Petitioners have presented no evidence, other than the Polacek memo, regarding the value of the furniture. That document ascribes to the furniture a corrected value of $11,856, which amount respondent, in his notice of deficiency, added to petitioners' income for 1976. In their reply brief, petitioners raise for the first time the argument that the market value of the furniture was only a percentage of the aforementioned book value. For reasons discussed above, we will not consider an argument not timely raised. Accordingly, because petitioners have offered no evidence of value, with regard to this issue, we hold for respondent.

V. Legal Fees

Mrs. Neely's father was president of the Oklahoma Publishing Co. (OPUBCO). He and Mrs. Neely's mother passed away within the span of a few months in 1974. Prior to that time, Mrs. Neely had regularly received financial information regarding OPUBCO and its subsidiaries from her father. The president of the corporation who succeeded him failed to provide Mrs. Neely certain financial information which she desired concerning OPUBCO's operations. Mrs. Neely, who held a substantial amount of OPUBCO stock in her own name, resorted to litigation in the Delaware courts to compel the corporation to make the financial information available to her. OPUBCO provided the requested information to Mrs. Neely before the case was tried and subsequently, in January 1978, repurchased her stock, as well as OPUBCO stock owned by Ralph Neely.

In the complaint initiating the lawsuit against OPUBCO, Mrs. Neely described her primary purpose for seeking the financial information as her desire "to ascertain the value of her shares of stock and to obtain any information which would enable her to solicit proxies, to sell her shares and to protect her rights and those of her family in the sale of shares of OPUBCO by the Executor in the probate proceedings." (These latter shares were part of the estates of her deceased parents and are not material to the issue at bar; the parties have reached a stipulated agreement with respect to legal fees paid in connection with the stock in the parents' estates.) In response to depositions and interrogatories in that action, petitioners' statements left no doubt that the underlying reason for the suit was Mrs. Neely's desire to sell her shares. Ralph Neely indicated that to his knowledge there was no reason, other than her desire to sell the stock, for her need to value it.

Petitioners paid legal fees in 1977 and 1978 in connection with the aforementioned litigation in the amounts of $12,550 and $32,903, respectively. They argue that these fees were properly deductible under section 212(2)[14] as expenses incurred "in connection with the management and conservation of shares of stock in the Oklahoma Publishing Co. held by Virginia G. Neely for the production of income." They assert that without the financial information, Mrs. Neely could not determine the value of her stock or whether OPUBCO was being properly managed. Respondent disallowed the deductions in both years and contends that the expenses should be capitalized and added to the basis of the stock. We agree.

The question which faces us is whether the expenses may be currently deducted under section 212(2) or should be capitalized as part of petitioners' basis in the stock. Petitioners maintain that although the suit against OPUBCO may have led to information ultimately used in the sale of the stock, the primary objective of the suit was to acquire information concerning the company's finances and management. We have previously said that in distinguishing between currently deductible and capital expenditures "with respect to litigation expenses in cases involving the acquisition, retention, or disposition of capital assets, the origin and character of the claim, not the purpose for which the claim is prosecuted, are the controlling criteria." *Estate of Davis v. Commissioner*, 79 T.C. 503, 508 (1982), citing *United States v. Gilmore*, 372 U.S. 39, 49 (1963), and *Woodward v. Commissioner*, 397 U.S. 572, 577 (1970), affg. 410 F.2d 313 (8th Cir. 1969), affg. 49 T.C. 377 (1968).

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[14] See note 12, *supra*.

Petitioners suggest that we examine the issues involved, the nature and objectives of the suit for which the expenditures were made, the defenses asserted, the purpose for the expenses, the background of the litigation, and all facts pertaining to the entire controversy out of which the disputed expenses arose, citing *Estate of Morgan v. Commissioner*, 332 F.2d 144, 151 (5th Cir. 1964). The considerations enumerated in *Morgan*, however, are of benefit only to the extent that they illuminate the origin and character of the lawsuit against OPUBCO. Although the narrow purpose of the suit was to compel disclosure of financial information, petitioner's sworn statements in the pleadings and discovery in that case clearly indicate that the origin of the claim was Mrs. Neely's desire to determine the value of her stock for the purpose of selling it.

The only evidence petitioners offer to the contrary is Ralph Neely's testimony in the instant case regarding Mrs. Neely's intention to sell the stock. His testimony, made with the benefit of hindsight, is directly contrary to petitioners' statements made under oath in the Delaware litigation. We believe the latter to be more probative in determining the origin and character of the claim in that suit.

We find that Mrs. Neely's desire to sell her stock was the origin of the lawsuit. It is settled that legal expenses incurred in litigation brought by a seller to determine the selling price of a capital asset are part of the cost of disposition of that asset and are to be treated as capital expenditures and not as deductible expenses. *Wagner v. Commissioner*, 78 T.C. 910, 918 (1982), citing *Woodward v. Commissioner*, *supra*; *Brown v. United States*, 526 F.2d 135 (6th Cir. 1975). Accordingly, with regard to this issue, we hold for respondent.

VI. Respondent's Amendment To Answer

Respondent filed, pursuant to Rule 41(c), a motion for leave to file a first amendment to answer in each of the docketed cases on March 4, 1985. The amendments lodged with the motion allege that portions of the deficiencies constitute substantial underpayments attributable to tax motivated transactions within the meaning of section 6621(d).[15] That section provides for a rate of interest which is 120 percent of the adjusted rate determined under section 6621(b), and is applicable with respect to interest accruing after December 31, 1984. Petitioners filed a notice of objection on March 22, 1985, alleging that the amendments raise new matter, namely, the need for an item-by-item determination of the extent to which the value claimed by petitioners for each piece donated was overstated. Petitioners contend that they would be denied the opportunity to cross-examine respondent's experts regarding these determinations, and that additional briefing would be required. They conclude that granting the motion to amend would therefore be prejudicial to them.

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[15] Sec. 6621(d) was added by sec. 144(a) of the Tax Reform Act of 1984, Pub. L. 98-369, 98 Stat. 682, 683, and provides, in pertinent part, as follows:

SEC. 6621. DETERMINATION OF RATE OF INTEREST.

(d) Interest on Substantial Underpayments Attributable to Tax Motivated Transactions.—

(1) In general.—In the case of interest payable under section 6601 with respect to any substantial underpayment attributable to tax motivated transactions, the annual rate of interest established under this section shall be 120 percent of the adjusted rate established under subsection (b).

(2) Substantial underpayment attributable to tax motivated transactions.—For purposes of this subsection, the term "substantial underpayment attributable to tax motivated transactions" means any underpayment of taxes imposed by subtitle A for any taxable year which is attributable to 1 or more tax motivated transactions if the amount of the underpayment for such year so attributable exceeds $1,000.

(3) Tax motivated transactions.—

(A) In general.—For purposes of this subsection, the term "tax motivated transaction" means—

(i) any valuation overstatement (within the meaning of section 6659(c)),

(ii) any loss disallowed by reason of section 465(a) and any credit disallowed under section 46(c)(8),

(iii) any straddle (as defined in section 1092(c) without regard to subsections (d) and (e) of section 1092), and

(iv) any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period.

* * * * * * *

(4) Jurisdiction of tax court.—In the case of any proceeding in the Tax Court for a redetermination of a deficiency, the Tax Court shall also have jurisdiction to determine the portion (if any) of such deficiency which is a substantial underpayment attributable to tax motivated transactions.

Sec. 6659(c) provides as follows:

SEC. 6659. ADDITION TO TAX IN THE CASE OF VALUATION OVERSTATEMENTS FOR PURPOSES OF THE INCOME TAX.

(c) Valuation Overstatement Defined.—For purposes of this section, there is a valuation overstatement if the value of any property, or the adjusted basis of any property, claimed on any return is 150 percent or more of the amount determined to be the correct amount of such valuation or adjusted basis (as the case may be).

We reject this argument. Petitioners offer no authority for the proposition that a valuation overstatement must be determined on an item-by-item basis and we know of none. In its report discussing the addition of section 6621(d), the Conference Committee noted that—

> a number of provisions of recent legislation have been designed, in whole or in part, to deal with the Tax Court backlog. Examples of these provisions are the increased damages assessable for instituting or maintaining Tax Court proceedings primarily for delay or that are frivolous or groundless (sec. 6673), the adjustment of interest rates (sec. 6621), the valuation overstatement and substantial understatement penalties (secs. 6659 and 6661), and the tax straddle rules (secs. 1092 and 1256).
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> * * * * * * *
>
> The conferees believe that, with this amendment, the Congress has given the Tax Court sufficient tools to manage its docket, and that the responsibility for effectively managing that docket and reducing the backlog now lies with the Tax Court. The positive response that the Court has made to several recent GAO recommendations is encouraging and the conferees expect the Court to implement swiftly these and other appropriate management initiatives. The conferees also note favorably the steps the Court has begun to take in consolidating similar tax shelter cases and dispensing with lengthy opinions in routine tax protestor cases. The Court should take further action in these two areas, as well as to assert, without hesitancy in appropriate instances, the penalties that the Congress has provided.
>
> [H. Rept. 98-861 (Conf.), 1984-3 C.B. (Vol. 2) 1.]

Section 6621(d) engrafts the definition of "valuation overstatement" contained in section 6659(c) as one of the tax motivated transactions it addresses. In discussing amendment proposals intended to put more teeth into section 6659 (regarding penalties for valuation overstatements), the conferees indicated that they were mindful of the need to dissuade—

> taxpayers from over-valuing charitable donations of property. This concern relates both to tax shelter promotions which exploit the deductibility of appreciation in capital-gain assets, and to other situations where individuals

> buy items on their own initiative specifically for contribution after expiration of the capital gains holding period, or overvalue items which they have held for long periods before donating them to a charity. [H. Rept. 98–861 (Conf.), 1984–3 C.B. (Vol. 2) 1, 252.]

These excerpts make clear the congressional intent behind enactment of section 6621(d). Adoption of the view propounded by petitioners would only serve to frustrate that intent and unduly burden the proceedings in this Court. For example, under petitioners' proposal, if a taxpayer were to make a donation of 10 items of equal value, 9 of which were each valued at 149 percent of its correct value and the last valued at 160 percent of its correct value, the higher interest under section 6621(d) would be imposed on only the valuation overstatement of the 10th item, and the overstatements of the 9 would be ignored. Likewise, if another taxpayer were to make a donation of 10 items of equal value, 9 of which were each valued at its correct value and the last valued at 150 percent of its correct value, the interest penalty would apply to the valuation overstatement of the 10th item, even though the 9 were properly reported. These results would unfairly reward the overreaching taxpayer in the first instance and unjustly punish the substantially compliant taxpayer in the second.

We therefore hold that with regard to a charitable contribution of the type at bar, where multiple items of a similar nature are given to a donee in a single transaction within a given tax year, the aggregate value claimed by a taxpayer should be compared to the aggregate amount determined to be the correct amount of such valuation for the purpose of determining whether there has been a valuation overstatement.[16]

We implicitly reached this conclusion in *Johnson v. Commissioner*, 85 T.C. 469 (1985), which involved a fact pattern similar to that in the instant case. In *Johnson*, the taxpayers made charitable contributions of over 100 American Indian artifacts in 1976 and nearly 200 etchings in 1977. The values claimed for those donations were grossly inflated, and this Court, sua sponte, considered the section 6621(d) issue. We held that the taxpayers were liable for the increased rate of interest because their substantial underpayments were attributable to tax motivated transactions. The determination of the valuation overstatements was made by comparing the values claimed on the taxpayers' returns with the amounts we determined to be the correct valuations of the artifacts and etchings.

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[16] The rule we adopt today might, in some cases, subject a taxpayer to an interest obligation greater than that which would obtain by using the method of determining the amount of a substantial underpayment proposed by petitioners. However, the evidence of record reveals that such is not the situation in the instant case.

Since we find that an item-by-item determination is unnecessary, petitioners' claim of prejudice is unfounded. We are unmoved by petitioners' vague reference to "serious constitutional questions that have not been litigated or briefed by the parties" regarding application of section 6621(d) to a taxpayer whose cases have been tried and submitted. That issue was laid to rest by *Johnson v. Commissioner, supra*, which, distinguishing *Law v. Commissioner*, 84 T.C. 985 (1985), held that consideration of the section 6621(d) issue after the close of briefing and argument is appropriate where the imposition of that section turns solely on the issue of valuation of contributed property.

Congress framed section 6621(d) in terms of "tax motivated transactions," and we believe that our holding today, by adopting a transactional approach, comports with the legislative objectives while affording taxpayers the most equitable application of the statute. We therefore grant respondent leave to file the amendments to answer lodged with his motion.

The values claimed by petitioners, the correct amounts of such valuations, and the percentage by which the former exceeds the latter are as follows:

Docket No.	*Tax year*	*Value claimed*	*Correct value*	*Percentage*
24184–81	1976	$321,200	$33,575	957
	1977	60,000	5,350	1121
	1978	683,975	75,055	911
26934–82	1979	270,780	33,775	802
	1980	167,150	20,100	832

We therefore find that there was a valuation overstatement in each of the years in issue. Because we have found, ante, that petitioners' underpayments of tax are in excess of $1,000 for each of these years, we conclude that the underpayments are substantial underpayments attributable to tax motivated transactions within the contemplation of section 6621(d) and that petitioners are liable for the rate of interest prescribed by that subsection for all interest accruing after December 31, 1984. Application of that rate shall be made to an amount (i.e., the substantial underpayment) determined pursuant to Rule 155 in accordance with respondent's Temporary and Proposed Regulation section 301.6621-2T, 49 Fed. Reg. 50390 (Dec. 28, 1984).

Decisions will be entered under Rule 155.

APPENDIX I

VALUATION DATA FOR 1978 DONATION

Partial Reproduction of Exhibit 11-K[1]				*Tax return*[5]	*Deficiency notice*[6]
Item	*Cost*[2]	*McNemar*[3]	*Willis*[4]		
1	$50	$950	$550	$2,100	$100
5	225	2,500	550	2,500	150
6	250	3,600	750	3,600	250
13	25	300	75	300	50
16	125	5,000	375	5,000	65
17A 17B	40	750	240	750	
18	15	300	40	300	50
22	35	1,100	450	1,100	
23	15	350	50	350	75
24	75		150	800	65
32	265	3,000	650	3,000	200
39	210	3,400	900	5,300	250
42	200	2,900	1,200	4,900	250
48	60	3,000	700	3,000	150
55	80	7,500	1,200	7,500	500

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[1] Exhibit 11-K is a detailed list of petitioners' African art collection originally compiled by L. Deupree in 1977 under the direction of McNemar, who later made additions to it. The first four columns are reproduced from that list.

[2] Figures in this column were added by McNemar and represent the price at which the piece was sold by McNemar to PAG.

[3] Figures in this column were added by McNemar in February 1978 and represent his opinion of value.

[4] Figures in this column were copied by McNemar from the appraisal report prepared in December 1976 by Willis.

[5] Figures in this column are excerpted from the appraisal report prepared in May 1979 by Hommel and are those claimed on petitioners' tax return as the fair market values of the art.

[6] Figures in this column are taken from the appraisal report prepared in September 1980 by Hersey.

VALUATION DATA FOR 1978 DONATION

Partial Reproduction of Exhibit 11-K				*Tax return*	*Deficiency notice*
Item	*Cost*	*McNemar*	*Willis*		
56	$38	$800		$1,000	$500
66	25	3,100	$700	2,100	300
67	35	2,100		2,500	350
68A	100	6,500	650	6,500	500
68B					
69A	150	6,300	750	6,300	1,000
69B					
86	125	1,100	400	2,500	300
87	125	1,800	600	2,300	300
96	150	2,300	700	4,500	250
97	110	3,500	700	4,500	400
100	250	3,900	2,000	5,000	850
134	325	3,800	600	6,200	1,000
140	275	4,200	800	8,000	1,000
160	310	4,200	1,200	9,500	250
266	1,400	40,000	3,000	40,000	850
270	175	3,600	800	3,600	500
271	175	3,900	500	3,900	1,250
276	125	1,400	300	1,300	300
279	125	900	?	1,100	250
281	300	4,800	700	3,500	500
285	15	375	50	375	200
288	5	325	40	325	350
289	5	400	30	400	125
290	10	400	30	400	150
291	10	400	35	400	50
292	5	375	40	425	125
293	5	375	40	375	150
294	5	500	60	500	150
295	5	500	40	500	150
296	10	350	35	350	125
310	150	3,600	900	3,600	500
311	75	4,500	700	4,500	100
313	10	200	40	300	150
314	10	350	45	400	125
316	200	3,100	500	3,100	250
318	200	3,300	500	3,300	250
321	200	2,100	600	2,100	75
352	210	3,800	900	4,800	1,000
355	75	2,800	900	3,200	850
356	75	2,800	900	3,200	200
367	20	500	300	500	150
393	100	3,000	1,000	5,500	1,250
394	100	3,700	900	3,700	750
396	100	9,000	3,200	9,000	2,500

VALUATION DATA FOR 1978 DONATION

Partial Reproduction of Exhibit 11-K					
Item	*Cost*[2]	*McNemar*[3]	*Willis*[4]	*Tax return*[5]	*Deficiency notice*[6]
404	$40	$5,900	$2,600	$4,000	$400
405	75	2,700	850	2,700	400
425	120	4,000	?	4,000	1,000
433	30	300	250	300	100
434	30	300	150	300	100
445	65	1,600		1,600	500
446	25	800	200	450	150
447	20	1,200	300	600	125
448	20	900	200	475	125
449	20	900	200	475	125
450	20	1,000	200	600	150
451	20	900	200	550	175
452	20	950	200	475	125
453	20	1,000	200	550	150
477	100	3,000	800	3,800	750
482	125	3,100	400	3,100	300
483	125	750	150	1,200	225
484	125	700	200	1,100	225
485	125	950	150	1,200	250
489	200	2,950	600	2,900	200
498	50	1,700	500	3,200	1,000
501	475	11,500	3,800	11,500	300
502	70	625	150	1,000	200
506	50	900	250	1,000	250
507	75	950	200	1,200	500
508	90	2,200	150	2,200	225
509	80	3,500	800	3,500	600
515	30	700	60	700	100
527	50	5,500	800	5,500	300
528	75	8,000	300	5,000	250
538	100	2,500	500	2,500	200
545	1,200	14,000	700	14,000	1,500
550	50	1,500	70	2,000	400
551	50	1,100	400	1,200	250
562	100	4,000	400	4,000	450
566	100	2,000	400	2,000	200
567	300	9,500	800	9,500	650
575	50	2,900	900	2,900	350
576	50	2,700	900	2,700	350
579	3,300	35,000	9,500	35,000	350
585	30	500	150	1,500	200
590	30	500	150	1,200	200
600	50	2,000	200	1,500	150
601	50	3,500	700	3,500	350

VALUATION DATA FOR 1978 DONATION

Partial Reproduction of Exhibit 11-K				Tax return	Deficiency notice
em	Cost	McNemar	Willis		
2	$50	$1,000	$200	$1,150	$125
6	150	3,000	200	3,000	100
7	10	5,500	1,800	5,500	200
5	70	1,400	350	1,500	200
7	125	3,000	250	3,500	500
25	30	900	250	950	200
31	160	5,000	500	5,000	250
32	175	9,000	600	9,000	250
33	200	4,200	1,800	4,200	250
39	200	3,200	550	4,800	250
43	200	3,100	550	5,000	275
44	75	3,200	900	2,000	100
46	200	15,000	6,500	15,000	100
48	150	3,200	1,000	3,200	450
52	150	3,000	1,000	3,200	450
54	300	5,800	1,200	5,000	350
58	325	12,500	1,500	12,000	600
59	325	12,500	1,500	11,000	650
60A 60B	1,200	25,000	6,500	25,000	1,500
64	200	3,500	1,500	3,500	200
65	500	4,000	1,500	4,000	500
67	100		400	2,000	750
68	50	900		1,400	500
83	175	2,500	550	1,450	250
95	100	3,100	950	5,500	500
96A 96B	300	7,500	4,500	7,500	1,250
704	125	3,200	1,000	3,200	750
706	100	3,200	800	3,200	450
712	400	1,800	600	4,500	500
713	250	2,500	500	4,000	900
728	250	6,800	2,500	5,000	500
729	250	4,800	2,000	4,800	5,000
734	265	2,500	600	2,500	500
738	415	2,200		3,000	250
747	110	2,500		2,500	100
752	100	7,500		7,500	250
755	300	6,500		6,500	1,000
772	200	4,200		4,200	300
776	250	9,000		9,000	200
782	410	21,000		21,000	400
784	275	8,500		8,500	250
794	20	650		650	250
795	75	3,100		3,100	500

VALUATION DATA FOR 1978 DONATION

Partial Reproduction of Exhibit 11-K				Tax return	Deficiency notice
Item	*Cost*	*McNemar*	*Willis*		
796	$40	$1,100		$1,200	$500
799	310	5,800		6,000	250
801	225	5,500		5,500	300
807	400	7,000		6,500	300
808	400	6,500		7,000	300
812	125	4,800		4,800	150
814	200	5,200		5,200	1,250
815	120	3,100		3,500	400
817	125	3,500		3,100	400
819	65	1,200		1,400	500
820	20	700		1,500	500
822	20	250		350	125
825	325	4,000		4,000	600
828	600	4,200		4,200	1,000
835	75	3,200		3,200	200
845	40	400		700	50
846	25	450		900	200
849	275	3,900		3,900	800
851	125	4,700		4,700	300
862	80	950		1,700	400
863	150	3,000		5,200	300
864	200	3,000		3,000	250
875	125	2,000		2,500	750
887	325	7,300		7,300	2,000
890	30	2,300		2,300	400
892	20	2,100		2,100	100
898	100	1,600		2,000	600

APPENDIX II

VALUATION DATA FOR 1979 DONATION

Partial Reproduction of Exhibit 11-K[1]					Tax return[6]	Deficiency notice[7]
Item	*Cost*[2]	*McNemar*[3]	*Willis*[4]	*Hommel*[5]		
40	$50	$2,600	$550	$2,600	$3,250	$1,000
44	200	3,100	1,200	4,800	6,000	300

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[1] Exhibit 11–K is a detailed list of petitioners' African art collection originally compiled by L. Deupree in 1977 under the direction of McNemar, who later made additions to it. The first four columns are reproduced from that list.

[2] Figures in this column were added by McNemar and represent the price at which the piece was sold by McNemar to PAG.

[3] Figures in this column were added by McNemar in February 1978 and represent his opinion of value.

VALUATION DATA FOR 1979 DONATION

Partial Reproduction of Exhibit 11-K					*Tax*	*Deficiency*
Item	*Cost*	*McNemar*	*Willis*	*Hommel*	*return*	*notice*
45	$35	$1,200	$500	$1,200	$1,500	$750
46	50	6,500	350	4,500	5,625	200
54	60	3,000	500	3,000	3,750	250
59	100	3,900	250	3,900	4,875	1,000
80	40	1,200	150	4,000	5,000	1,000
89	125	3,800	800	3,800	4,750	500
90	135	4,100	400	4,100	5,125	400
91	90	2,300	400	2,300	2,875	250
92	125	1,900	300	1,900	2,375	450
94	110	2,300	400	3,300	4,125	400
95	175	2,300	700	5,000	6,250	400
114	50	3,100	900	3,100	3,875	1,000
125	160	3,900	850	3,900	4,875	700
139	160	4,000	1,000	4,000	5,000	1,000
145	150	2,800	450	4,500	5,625	250
149	250	2,500	350	5,000	6,250	350
173	125	3,500	900	3,500	4,375	1,000
180	40	2,000	250	2,000	2,500	45
181	30	700	150	1,000	1,250	40
188	40	900	200	1,100	1,375	45
192	35	1,100	150	1,100	1,375	30
193	30	350	150	950	1,190	40
198	25	650	150	900	1,125	40
206	25	750	150	1,100	1,375	35
207	35	850	150	1,000	1,250	40
208	35	900	150	1,300	1,375	35
210	40	750	150	1,000	1,250	40
212	80	4,300	700	4,300	5,375	100
214	25	650	150	1,000	1,250	35
215	25	750	150	900	1,125	40
217	30	475	150	700	875	40
218	30	1,300	150	1,500	1,875	50
219	40	900	150	1,100	1,375	45
220	45	1,500	150	1,500	1,875	60
222	40	750	150	1,000	1,250	35
223	25	800	150	1,100	1,375	125

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[4] Figures in this column were copied by McNemar from the appraisal report prepared in December 1976 by Willis.

[5] Figures in this column are excerpted from the appraisal report prepared in May 1978 by Hommel.

[6] Figures in this column are taken from Hommel's October 1979 reappraisal of the art and are those claimed on petitioners' tax return as the fair market values of the art.

[7] Figures in this column are the greater of the value determined by Hersey in his September 1980 appraisal report or the value determined by Sieber in his July 1981 appraisal report.

VALUATION DATA FOR 1979 DONATION

Partial Reproduction of Exhibit 11-K					*Tax return*	*Deficiency notice*
Item	*Cost*	*McNemar*	*Willis*	*Hommel*		
226	$50	$1,000	$150	$1,200	$1,500	$45
230	30	475	150	900	1,125	40
232	30	750	150	900	1,125	35
234	35	1,600	250	1,600	2,000	50
235	90	1,800	400	2,200	2,750	1,000
239	50	725	150	1,200	1,500	100
240	50	1,800	150	2,000	2,500	85
241	40	650	150	1,600	2,000	45
242	60	1,400	150	2,400	3,000	50
243	30	1,500	150	1,500	1,875	50
244	50	750	150	2,000	2,500	125
246	30	600	150	2,000	2,500	40
247	40	900	150	2,000	2,500	45
249	30	950	150	950	1,190	55
252	35	1,400	150	1,400	1,750	45
254	30	750	150	1,000	1,250	40
256	30	1,000	150	1,000	1,250	35
258	50	825	150	1,500	1,875	50
259	35	1,000	150	1,200	1,500	40
260	35	1,100	150	1,400	1,750	30
262	30	650	150	1,000	1,250	35
263	50	1,700	150	1,700	2,125	35
286	40	1,000	200	2,100	2,650	500
287	10	275	40	500	625	100
333	80	1,800	300	3,600	4,500	400
334	75	2,000	300	2,000	2,500	500
338	30	950	?	950	1,190	35
339	150	4,100	?	4,100	5,125	1,000
344	110	3,200	1,200	4,000	5,000	1,000
357	75	2,800	900	3,200	4,000	500
359	75	3,000	900	3,500	4,375	500
361	75	2,800	900	3,200	4,000	500
362	75	3,000	900	3,500	4,375	500
407	125	3,200	1,800	3,200	4,000	800
418	75	3,000	400	3,000	3,750	1,500
435	30	300	150	300	375	75
437	30	300	150	300	375	75
438	30	300	150	300	375	85
469	30	300	150	300	375	75
580	50	3,100	900	3,100	3,875	500
581	50	3,900	900	3,900	4,875	500
582	50	2,500	900	2,500	3,125	500
891	30	250		250	310	75
900	125	2,900		2,900	3,625	800
945	150	3,800		3,800	4,750	800

VALUATION DATA FOR 1979 DONATION

Partial Reproduction of Exhibit 11-K					*Tax*	*Deficiency*
Item	*Cost*	*McNemar*	*Willis*	*Hommel*	*return*	*notice*
958	$250	$6,000		$6,000	$7,500	$1,000
993	35	400	$150	1,000	1,250	35
1043	20	900		1,300	1,625	1,000
1101	20	300	70	700	875	200
1109	100	1,200	70	1,500	1,875	1,000
1157	50	600	300	2,000	2,500	850
1159	50	1,800	500	3,300	4,125	800
1160	50	1,600	500	3,000	3,750	500
1174	120	650	150	3,500	4,375	125
1194	75	3,200	700	3,200	4,000	200
1206	80	2,200	400	3,500	4,375	500
1231	125	4,300	1,000	3,700	4,625	800
1240	75	2,900	1,100	4,000	5,000	1,250

APPENDIX III

VALUATION DATA FOR 1980 DONATION

Partial Reproduction of Exhibit 11-K[1]				*Tax*	*Deficiency*
Item	*Cost*[2]	*McNemar*[3]	*Willis*[4]	*return*[5]	*notice*[6]
9	$200	$2,900	$700	$2,900	$400
443	450	7,500	2,500	7,500	600
888	350	9,500		9,500	550
956	300	5,900		5,900	600
1106	625	3,850	900	4,300	1,200
1200	50	4,500	900	4,500	1,500
1201	225	5,500	1,200	5,500	350
1232	120	3,300	750	3,300	350
1233	120	3,300	750	3,300	350
1278	20			1,400	1,000

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[2] Figures in this column were added by McNemar and represent the price at which the piece was sold by McNemar to PAG.

[3] Figures in this column were added by McNemar in February 1978 and represent his opinion of value.

[4] Figures in this column were copied by McNemar from the appraisal report prepared in December 1976 by Willis.

[5] Figures in this column are excerpted from the appraisal report prepared in May 1978 by Hommel and are those claimed on petitioners' tax return as the fair market values of the art.

[6] Figures in this column are the greater of the value determined by Hersey in his September 1980 appraisal report or the value determined by Sieber in his July 1981 appraisal report.

VALUATION DATA FOR 1980 DONATION

Partial Reproduction of Exhibit 11-K				*Tax return*	*Deficiency notice*
Item	*Cost*	*McNemar*	*Willis*		
1279	$20			$1,400	$1,250
1281	20			1,400	1,000
102	200	$6,500	$800	8,125	500
103	200	6,800	800	8,500	450
182	30	500	150	1,250	50
268	1,400	42,000	2,000	52,500	700
353	210	4,000	900	6,250	250
586	30	500	150	1,750	200
905	125	1,600		3,750	2,500
906	125	1,800		3,750	2,500
948	125	3,300		4,125	1,000
949	200	4,200		4,375	1,000
954	200	5,300		6,625	600
964	200	6,000		7,500	550
966	225	6,200		7,750	650

DENNIS S. BROWN, ET AL.,[1] PETITIONERS V. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 29929–82, 2313–83 Filed December 18, 1985.
3083–83, 3503–83.

Petitioners claimed deductions for fees and losses allegedly incurred with respect to forward contracts for purchase and sale of Ginnie Maes and Freddie Macs. *Held*, the forward contracts and related transactions were factual shams and the deductions for fees and losses are disallowed. *Held, further*, the addition to tax under sec. 6653(a) I.R.C. of 1954 as determined by respondent against one petitioner is sustained, but damages under sec. 6673 are declined.

Joseph Wetzel and *Russell Sandor*, for the petitioners.
Ralph C. Jones and *Joyce Britt*, for the respondent.

SHIELDS, *Judge*: Respondent determined deficiencies in petitioners' Federal income tax as follows:

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[1] Cases of James E. Sochin, docket No. 2313–83; Ellison C. Morgan and Linda Morgan, docket No. 3083–83; and James N. Leinbach and Mary Alice Leinbach, docket No. 3503–83, were consolidated herewith for trial, briefing, and opinion.

Petitioner [2]	*Year*	*Deficiency*	*Additions to tax sec. 6653(a)*[3]
Brown	1979	$49,562.50	
Sochin	1979	9,402.00	
	1980	25,535.00	
	1981	18,288.00	
Morgan	1977	2,283.00	$114.00
	1979	104,022.00	5,217.35
	1980	194,141.55	10,141.55
Leinbach	1979	205,181.69	
	1980	263,728.31	
	1981	218,036.46	

After concessions, the issues remaining for decision are: (1) Whether petitioners realized deductible losses under section 165(c)(2) on forward contracts as claimed on their income tax returns for 1979, 1980, and/or 1981; (2) whether the fees paid by petitioners with respect to such contracts are deductible; (3) whether petitioners, Ellison C. Morgan and Linda Morgan, are liable for additions to tax under section 6653(a); and (4) whether any of the petitioners are liable for damages under section 6673.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulations and exhibits associated therewith are incorporated herein by reference.

All of the petitioners resided in Oregon at the time their petitions were filed, and all of them filed income tax returns for 1979, 1980, and 1981 with the Internal Revenue Service Center at Ogden, Utah. On the returns, petitioners claimed to have suffered losses in the following amounts from the cancellation of forward contracts for the purchase or sale of certain mortgage certificates:

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[2] Since Linda Morgan and Mary Alice Leinbach are petitioners solely because they filed joint returns with their husbands, the word "petitioners" as used hereinafter will refer only to the male petitioners unless otherwise indicated.

[3] All section references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue. All rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner	*Year*	*Loss claimed*
Brown	1979	$106,160
Sochin	1979	20,621
	1980	48,054
	1981	38,785
Morgan	1979	224,416
	1980	390,614
Leinbach	1979	394,676
	1980	482,245
	1981	401,412

All of the above losses allegedly[4] occurred with respect to activities promoted by Gregory Government Securities, Inc., and Gregory Investment & Management, Inc. Over 1,400 other cases now pending before this Court have been identified as involving similar issues and factual situations. Upon learning of the number of such cases, the Chief Judge assigned all of them to this division of the Court. With the assistance of respondent and his counsel, and most of the 1,400 petitioners and their counsel, these four cases were selected as being generally representative with respect to the issues common to all the cases.[5] An order was then entered consolidating these four cases and setting them for trial of the common issues while all activity in the other cases was suspended pending the decision herein.

Gregory Government Securities, Inc. (GGS), and Gregory Investment & Management, Inc. (GIM) were incorporated in 1979 by William H. Gregory under the laws of the State of Oregon. At all times material to these cases, all of the stock outstanding in both corporations was owned by Mr. Gregory and his wife, and their corporate activities were conducted under his general supervision and control. Prior to 1979, Mr. Gregory had been the tax partner and a specialist in accounting for wood products with Arthur Andersen & Co., an international accounting firm. He was also the chairman of the firm's steering committee on tax shelters. He left Arthur

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[4] The use in our findings of such words and phrases as loss, gain, forward contract, cancellation, assignment, spread, straddle, short position, long position, transactions and similar words and phrases are for convenience only and are not to be construed as a determination of the nature of any act or thing.

[5] The additional loss issue raised by petitioner Morgan in his amended pleading filed Apr. 19, 1984, was not considered herein because these proceedings deal only with the issues common to all petitioners. The additional issue will be considered in a later proceeding.

Andersen in July of 1979 in order to establish GGS and GIM. Shortly after its organization, GGS was registered with the Oregon Department of Commerce as a broker-dealer in securities. The registration continued through the balance of 1979 and throughout 1980 and 1981. No such registration was required of GIM in Oregon. Neither corporation was required to be registered as a broker-dealer under the Securities Exchange Act of 1934.

The promotion undertaken in 1979 by Mr. Gregory was purportedly to offer to "a limited number of knowledgeable, sophisticated investors, * * * who understand both the economic and tax ramifications of the transactions," investments in forward contracts to purchase or to sell certificates issued by Government National Mortgage Association and Federal Home Loan Mortgage Corporation. These certificates are exempt from federal registration under the Securities Act of 1933. His program contemplated that GIM would serve as a financial adviser to the prospective investors, and GGS, as a registered broker-dealer, would serve as either a seller or a buyer on every transaction entered into with the investors.

Government National Mortgage Association (GNMA) is a corporation wholly owned by the Government through the Department of Housing and Urban Development. From time to time, GNMA issues registered certificates which represent undivided interests in a specified pool of mortgages guaranteed by GNMA, as well as by the Veterans' Administration, the Federal Housing Administration, or the Farmers Home Administration. These certificates are referred to in the market as "Ginnie Maes."

The Federal Home Loan Mortgage Corporation (FHLMC) is a corporation whose capital stock is owned by the Federal Home Loan Bank Board and whose directors are appointed by the President with the advice and consent of the Senate. The directors of the Federal Home Loan Bank Board act as the directors of FHLMC.

FHLMC also sells mortgage certificates which are known as participation certificates and which are referred to in the market as "Freddie Macs." Each of these certificates represents an undivided fractional interest in a pool of conventional (non-VA and non-FHA) mortgages.

Each prospective investor,[6] including petitioners herein, was given a disclosure memorandum by GIM in which the investment strategy developed by Mr. Gregory was described as follows:

> Gregory Investment assists investors in profiting from changes in yields on U.S. Government securities. The investor provides us with his forecast of interest rates. We recommend a portfolio of U.S. Government securities that we believe will result in a gain, if the investor's forecast is correct.
>
> The investment usually involves the purchase and sale of securities under arrangements that delay the actual delivery of the security for several months. This type of arrangement is referred to as a forward contract.
>
> A forward contract is a bilateral executory agreement pursuant to which one party agrees to deliver a designated amount of an item at a certain price and time to another party, who agrees to acquire such item at such price and time. The forward contract does not require delivery until the settlement date designated in the contract. A forward contract is similar in concept to a futures contract. However, a futures contract is consummated through a board of trade or an exchange and contains standardized terms and conditions. The securities purchases and sales through forward contracts are limited to obligations of, or obligations guaranteed by, the United States Government, and securities issued by or guaranteed by United States Government corporations or agencies; e.g., Government National Mortgage Association (GNMA) or Federal Home Loan Mortgage Corporation (FHLMC). The customer is required by the contract to make delivery to, or take delivery from, the dealer of the security specified in the forward contract at settlement date.
>
> It is contemplated that a customer will enter into several forward contracts with the dealer, some of which will require the customer to make forward delivery to the dealer of securities, while others will require the customer to take forward delivery from the dealer of securities. The forward contracts entered into by a particular customer will reflect a market strategy and interest rate forecast and could result in substantial gain or loss to the customer, depending on the volume of transactions and whether interest rate movement is in accordance with, or adverse to, his expectations.
>
> The investment risk is diminished by the simultaneous purchase and sale of a forward contract. This purchase and sale is called a spread. The profit and loss potential of a spread results from the purchase of securities and the sale of securities with different coupon interest rates.
>
> A change in interest rates affects the price of a low-coupon security a greater percentage than a high-coupon security. However, the low-coupon

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[6] At trial and on brief, petitioners contended that evidence of transactions between Mr. Gregory, GGS, or GIM and any investor other than petitioners is not relevant to the issues under consideration and therefore should not be admitted. After due consideration, we affirm the temporary decision made at the trial that such evidence is admissible in order to determine whether the transactions with petitioners are bona fide.

security costs less, so even though its price varies at a greater percentage rate, the total change in price is less.

The usual investment strategy to profit from rising interest rates is to *purchase low-coupon* and *sell high-coupon* securities. An opposite strategy would be used for a projected decline in interest rates.

For example—

Assume a 9% current yield to maturity on a security paying interest semiannually and maturing in ten years. The investor forecasts interest rates to rise to 10%. This spread results in a profit:

			Price		
	Coupon rate	*Face value*	*9-Percent yield*	*10-Percent yield*	*Profit (loss)*
Purchase (long)	8%	$1,000,000	$935,000	$875,400	$(59,600)
Sell (short)	9	1,000,000	1,000,000	937,700	62,300
					2,700

The profit would be reduced by transaction costs.

* * * * * * *

In the event a customer desires to be released from obligations under a particular forward contract, the customer may attempt to arrange for the cancellation of the obligations under the contract prior to settlement date. If the dealer agrees to cancel the contract, it will charge or credit the customer's account with an amount equal to the profit or loss that the customer is entitled to receive. In consideration for the release of the customer from his obligation to perform the contract the customer will also pay a fee to the dealer for risk and administrative costs created by the cancellation of the contract.

Alternatively, if the customer does not desire to be released from the obligations under a particular forward contract (original contract), but wants to eliminate the risk created by such contract, he may enter into a forward contract bearing the position opposite that of the original contract. The customer may request that the dealer offset the newly acquired contract against the original contract or he may keep both positions open and either offset at a later date or close out the position in some other manner.

The tax and economic results of various types of transactions are summarized below. The federal income tax results should be discussed with your tax advisor and you should not rely on the chart. The results could be challenged for various reasons by the Internal Revenue Service, as explained in the tax aspects section of this memorandum.

TRANSACTION	FEDERAL INCOME TAX RESULTS	ECONOMIC RESULTS
Delivery of securities	Long position: none until securities are sold. Short position: short-term capital gain or loss	Gain or loss is realized. Additional margin may be required because of increased risk unless a spread is re-established or all positions are closed.
Sale or assignment	Long-term capital gain or loss on contracts held over 1 year. Short-term 1 year or less.	
Cancellation	Ordinary gain or loss.	
Offset or pair-off of identical contract	Short-term capital gain or loss on all short positions and on all long positions held for 1 year or less on date of short sale.	
Opposing purchase or sale of securities identical to open positions	None	Establishes no risk situation locking in gain or loss for later realization.
Opposing purchase or sale of securities different from open positions	None	Establishes spread with potential for gain or loss.

The memorandum stated that the forward contracts were not listed on any security or commodity exchange; that each contract was between the investor as one party and GGS as the other; that the investor could not sell or assign his interest in any contract without the consent of GGS; that if the investor wished to be released from the obligations of a particular forward contract before its settlement date, he had the right to request that GGS cancel the contract; and that if GGS agreed to do so, the investor's account would be credited by GGS with an amount equal to any profit the investor was entitled to receive or charged with any loss he had suffered on the contract plus a fee for the "risk and administrative costs created by the cancellation of the contract."

The memorandum also stated that each investor was required to have on deposit with GGS a sufficient amount to cover his investment risk which amount would vary with the size of the portfolio and the risk involved but the initial deposit would be a minimum of $10,000 or 0.125 percent of the face value of the portfolio, whichever was greater. An advisory fee of 0.001 percent per month was to be paid out of the deposit with GGS to GIM. In addition, an origination fee of 0.04 percent of the contract's face value was payable on the trade date, and the fee for the cancellation of a contract was stated to be 0.02 percent of the face value on the cancellation date. GGS could also include a markup or a discount on any security covered by a contract.

Potential investors were warned by the disclosure memorandum that they could lose all of their deposit in a relatively short period of time and that in order to achieve a profit, the market would have to move in the direction forecast and by an amount that covered all fees plus or minus any markup or discount.

GIM's disclosure memorandum contained 14 pages, 4 of which were devoted to the tax treatment that Mr. Gregory thought an investor could expect as a result of entering into a transaction with GGS and GIM. Briefly, the transaction would proceed as follows: (1) The investor would make his deposit and furnish GIM with an interest rate forecast for the next 3, 12, and 15 months. (2) Using the interest forecast GIM, acting as an investment adviser, would prepare a portfolio of forward contracts on Ginnie Maes and Freddie Macs in the face amount required by the deposit and which, if the investor's prediction proved to be correct, would supposedly result in a profit. (3) Each of the forward contracts was entered into by the investor with GGS. In each case, the original portfolio for an investor constituted a spread or straddle since 50 percent of the contracts were long positions (contracts to purchase securities) and 50 percent were short positions (contracts to deliver securities). (4) As time passed and it became apparent which leg of the straddle would result in a loss,[7] that leg would be canceled and the gain in the other leg of the straddle would be locked in by entering into an offsetting or opposing contract to purchase or sell until such time as the investor wished to realize his gain (presumably after it became a long-term capital gain).

According to GIM's memorandum, the tax result of the above transaction would be an ordinary loss for the investor in the year of the cancellation of the loss contracts and a long-term capital gain in the year the gain was realized by the sale or assignment of the gain contracts. The memorandum, however, did contain the following caveat:

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[7] Everything else being equal, any significant change either up or down in the prevailing interest rate would result in a gain in one leg and a loss in the other.

> Due to the tax deferral and conversion of tax characteristics (i.e., capital versus ordinary) involved in the transactions described in this memorandum, the Service may take a strong stance contrary to the opinions expressed herein. Additional legislative action or Service rulings or regulations could also be enacted or issued negating any tax benefits that would otherwise be available to the investor as discussed in this memorandum. Further, if a court should feel that tax deferral or conversion is involved, it might be inclined to hold in favor of the Service, even though the opinions expressed in this memorandum are technically correct. The investor should review the tax treatment of the transactions discussed in this memorandum with his tax advisor and rely only upon the advice of his own tax advisor. The opinions expressed herein are only for purposes of providing information and analysis to the investor and his tax advisor.

Attached to the disclosure memorandum is a copy of the Service's Rev. Rul. 77–185, 1977–1 C.B. 48, 50. This ruling holds that "Neither a short-term capital loss created to minimize the tax consequences of an unrelated short-term capital gain through a series of transactions in silver futures contracts, which result in no real economic loss, nor the related out-of-pocket expenses incurred in connection with creating the loss are deductible under section 165(a) of the Code."

In spite of the caveat, prospective investors were advised that with a minimum deposit of $10,000 they could obtain forward contracts with GGS having a total face value of $8 million. They were also advised that for the minimum deposit, one or the other of the long or short positions (depending on the direction of the movement in the interest rate) would result in an ordinary loss in the approximate amount of 10 times the deposit or $100,000.

Each investor was required to sign a client or customer agreement which provided, among other things, that whenever GGS "considered it necessary for [its] protection," GGS could liquidate any open position or cancel any order through public or private action with or without notice to the investor; and in the event of death or incapacity of an investor, GGS could take any step it deemed appropriate to cancel or complete any open position. A power of attorney was also obtained from every investor. Under the power of attorney, GGS was authorized to follow the investment instructions of GIM in every respect, and GIM was authorized to act for the investor and perform in his behalf any act which he could perform in person. The power of investor "ratif[ied] and confirm[ed] any and all transactions with [GGS] heretofore or hereafter made by [GIM] or for [his] account."

Even though GGS was a party to each of the forward contracts entered into by petitioners and had the right to include a markup or discount in any transaction, Mr. Gregory and David Solberg, the vice president and later president of GGS, admitted that neither GGS nor GIM made any profit from the contracts. Instead, their profits were generated from the advisory, origination, cancellation, and other fees.

GGS was required by the deputy corporation commissioner for the State of Oregon to establish and maintain a hedging program in publicly traded Ginnie Maes to insure its performance on forward contracts. GGS supposedly satisfied this requirement by hedging its net exposure on the total of its forward contracts by an offset with publicly traded Ginnie Maes.[8]

Under the client agreement, GGS had the authority to determine any price required under the contracts including cancellation prices. In order to arrive at a price, GGS purportedly used an elaborate formula consisting of approximately 20 steps. The first step was the receipt of a quotation in the open market for the then-current 8-percent Ginnie Maes. This price was then converted to a yield stated as a percentage which was used in computing a comparable value for the security being priced. The formula contained several other adjustments to be made in arriving at a price for a contract. Surprisingly enough, these included a step which allowed GGS to make any adjustment it felt was appropriate. At trial, Mr. Gregory admitted that on more than one occasion price concessions had been made to an investor if he felt that the investor's pricing expectations would be "disappointed" by adhering too strictly to market quotations or pricing formulas.

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[8] GIM's disclosure memorandum contains the following provision on the risk of non-performance:

"Government Securities' [GGS's] ability to perform its obligation on settlement date will depend on the financial condition of Government Securities. Government Securities attempts to limit its economic risk by hedging its forward contract positions with either offsetting sales to or purchases from other customers. To the extent that Government Securities may have an imbalance between its long and its short positions (i.e., its net exposure), it will attempt to minimize that risk with offsetting purchases or sales of GNMA securities or GNMA futures contracts."

Following generally the procedure outlined in GIM's disclosure memorandum, petitioners and all other investors in the program made their respective deposits and furnished their interest forecasts to GIM and, in return, received documents which indicated their entry into forward contracts with GGS to purchase and sell Ginnie Maes and Freddie Macs. The documents included copies of the interest forecasts, forward contracts, powers of attorney, and client agreements referred to in the memorandum. The documents consisted of standard preprinted forms provided by GIM, and no negotiation or alterations by the investors was permitted as to their terms except with respect to the interest forecasts. The forms were executed by the investors or were executed for them by GIM pursuant to the powers of attorney. For the most part, investors in the Gregory program first became aware of the terms of their contracts when they received the copies from GGS.

The interest rate forecasts made by petitioners for 1979 were as follows:

	Brown	*Sochin*	*Morgan*	*Leinbach*
Date of forecast	10/03/79	09/18/79	09/28/79	10/03/79
Current rate	10.9	10.586	10.8	10.915
3 Months	up 40	up 50	up 40	up 40
12 Months	down 100	down 90	down 100	up 100
15 Months	down 150	down 100	down 150	down 100

For illustration purposes, Brown's forecast which was made on October 3, 1979, was to the effect that the 10.9-percent rate at which 8-percent Ginnie Maes were then trading on the Chicago Board of Trade would increase in 3 months by 40 basis points (0.04 percent), decrease in 12 months by 100 basis points (0.1 percent), and decrease in 15 months by 150 basis points (0.15 percent). Each of the other forecasts can be interpreted in a similar manner.

Each petitioner gave his 1979 forecast to GIM together with his 1979 deposit and, shortly thereafter, was furnished by GGS with a portfolio containing the forward contracts recommended by GIM, which according to GIM and GGS, would generate for petitioner a tax deduction of approximately $10 for each $1 of his deposit plus a gain if petitioner's interest forecast proved to be accurate.

Brown's account number with GGS was 135 and, according to the records of GGS, a transcript of the activity in the account with respect to the 1979 investment is as shown in the table on page 980.

The above transcript of Brown's account purportedly indicates that in return for his $10,000 deposit the initial portfolio recommended by GIM for him contained forward contracts 1 to 7 (all dated October 4, 1979) of which the first three represented agreements by Brown to buy Ginnie Maes from GGS having a total value of $4 million, and the last four of which represented agreements by Brown to sell to GGS Freddie Macs having a total value of $4 million. Six days later, on October 10, 1979, the contracts to buy Ginnie Maes (1 to 3) were canceled by GGS at an ordinary loss for Brown of $100,160[9] and the $4 million in Freddie Macs included in the remaining sell contracts (4 to 7) were offset by contract number 8 to buy Freddie Macs from GGS in the amount of $4 million. On October 26, 1979, Brown's position in the buy and sell contracts of 4 to 8 were locked down by the contracts of 9 to 13.

On January 22, 1981, both the contracts to buy and the contracts to sell Freddie Macs (4 to 13) were disposed of at a net long-term capital gain to Brown of $106,382 by an assignment to RST Investment Co. (RST), a partnership. RST was an investor with GGS and GIM and its members were business associates of Mr. Gregory. The assignment was executed for Brown by GIM under his power of attorney.

Sochin was a one-sixth participant in GGS's account number 112 which was in the name of Harsh Associates. GGS's transcript of the activity in the account with respect to the 1979 investment is as shown in table on page 981.

The transcript of the Harsh Associates account, in which Sochin was a one-sixth participant, purportedly indicates that for a deposit of $12,000 Harsh Associates received an initial portfolio containing forward contracts 1 to 7 (all dated September 18, 1979) of which the first three represented agreements by Harsh to buy from GGS Ginnie Maes having a total value of $4,800,000 and the last four represented agreements by Harsh to sell to GGS Freddie Macs having a total value of $4,800,000. Sixteen days later, on October 4, 1979, the contracts to buy Ginnie Maes were canceled and the contracts to sell $4,800,000 in Freddie Macs as represented by contracts 4 to 7 were offset

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[9] The record does not contain an explanation for the difference between this figure and the figures used on the return and the statutory notice, both of which reflect a loss of $106,160.

1979

DENNIS S. BROWN

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 135

Contract number	*DSB buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss)*		
1	Buy	2.0	GNMA	10/04/79	7.5	3/10/81	78.464	C 10/10/79	76.003	($49,220)		
2	Buy	1.0	GNMA	10/04/79	8.25	3/01/81	82.546	C 10/10/79	80.010	(25,360)		
3	Buy	1.0	GNMA	10/04/79	9.0	3/30/81	84.943	C 10/10/79	82.385	(25,580)		($100,160)
4	Sell	1.0	FHLMC	10/04/79	8.75	3/15/81	84.025	A 1/22/81	76.7572	72,678		
5	Sell	1.0	FHLMC	10/04/79	9.0	4/01/81	84.443	A 1/22/81	77.1969	72,461		
6	Sell	1.0	FHLMC	10/04/79	9.25	2/15/81	85.416	A 1/22/81	78.1425	72,735		
7	Sell	1.0	FHLMC	10/04/79	9.5	3/01/81	86.365	A 1/22/81	79.0841	72,809		
8	Buy	4.0	FHLMC	10/10/79	8.0	4/15/81	78.500	A 1/22/81	73.8769	(184,924)		
9	Sell	4.0	FHLMC	10/26/79	8.0	5/15/81	74.9974	A 1/22/81	73.8769	44,820		
10	Buy	1.0	FHLMC	10/26/79	8.75	4/15/81	77.8633	A 1/22/81	76.7572	(11,061)		
11	Buy	1.0	FHLMC	10/26/79	9.0	5/01/81	78.3042	A 1/22/81	77.1969	(11,073)		
12	Buy	1.0	FHLMC	10/26/79	9.25	3/15/81	79.2472	A 1/22/81	78.1425	(11,047)		
13	Buy	1.0	FHLMC	10/26/79	9.5	4/01/81	80.1857	A 1/22/81	79.0841	(11,016)		
										A net gain	=	106,382
										C + A net, net gain		6,222
										Fees		(6,100)
										Net profit to client		122

1979

HARSH ASSOCIATES

(James E. Sochin (1/6))

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 112

Contract number	*JES buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss) (JES share)*	
1	Buy	2.4	GNMA	9/18/79	7.5	3/10/81	80.515	C 10/04/79	78.056	($9,836)	
2	Buy	1.2	GNMA	9/18/79	8.25	3/01/81	85.231	C 10/04/79	82.662	(5,138)	
3	Buy	1.2	GNMA	9/18/79	9.0	3/30/81	87.047	C 10/04/79	84.494	(5,106)	($20,080)
4	Sell	1.2	FHLMC	9/18/79	8.75	3/15/81	86.140	A 12/17/80	76.4849	19,302	
5	Sell	1.2	FHLMC	9/18/79	9.0	4/01/81	86.547	A 12/17/80	76.9291	19,236	
6	Sell	1.2	FHLMC	9/18/79	9.25	2/15/81	87.531	A 12/17/80	77.8741	19,314	
7	Sell	1.2	FHLMC	9/18/79	9.5	3/01/81	86.513	A 12/17/80	78.8149	19,396	
8	Buy	4.8	FHLMC	10/04/79	8.0	4/15/81	80.563	A 12/17/80	73.6124	(55,605)	
9	Buy	1.2	FHLMC	10/23/79	8.75	4/15/81	76.704	A 12/17/80	76.4889	(430)	
10	Buy	1.2	FHLMC	10/23/79	9.0	5/01/81	77.1499	A 12/17/80	76.9291	(442)	
11	Buy	1.2	FHLMC	10/23/79	9.25	3/15/81	78.087	A 12/17/80	77.8741	(426)	
12	Buy	1.2	FHLMC	10/23/79	9.5	4/01/81	79.0193	A 12/17/80	78.8149	(409)	
13	Sell	4.8	FHLMC	10/23/79	8.0	5/15/81	73.8655	A 12/17/80	73.6124	2,025	
										A net gain =	21,961
										C + A net, net gain	1,881
										Fees	(1,420)
										Net profit to client	461

by a contract to buy from GGS Freddie Macs in the amount of $4,800,000. On October 23, 1979, Harsh Associates' positions in the buy and sell contracts 4 to 8 were locked down by contract numbers 9 to 13. For his proportionate deposit of $2,000 Sochin claimed an ordinary loss from the October 4 cancellation in the amount of $20,080.[10]

On February 12, 1981, both the contracts to buy and the contracts to sell Freddie Macs (4 to 13) were purportedly disposed of at a net long-term capital gain to Sochin of $21,961 by an assignment to RST. The assignment was executed for Sochin and the other members of Harsh Associates by GIM under its power of attorney.

Morgan was one of six participants in GGS's account number 127. His interest in the account, however, was 31.43 percent. The account was in the name of RMC Associates. The transcript of account number 127 reflects the activity shown in the table on page 983 with respect to the 1979 investment.

The transcript of RMC Associates' account purportedly indicates that for their $70,000 deposit they received an initial portfolio containing forward contracts 1 to 7 (all dated September 28, 1979), of which the first three represented agreements by them to buy from GGS Ginnie Maes having a total value of $28 million, and the last four represented agreements by them to sell to GGS Freddie Macs having a total value of $28 million. Eleven days later, on October 9, 1979, the contracts to buy Ginnie Maes were canceled by GGS and the $28 million in Freddie Macs which were included in sell contracts 4 to 7 were offset by contract 8 to buy from GGS Freddie Macs having a total value of $28 million. On October 22, 1979, RMC Associates' position in contracts 4 to 8 to buy and sell Freddie Macs was locked down by contracts 9 to 13. For his proportionate deposit of $22,000, Morgan claimed an ordinary loss from the October 9 cancellation in the amount of $219,340.[11]

On February 12, 1981, both the contracts to buy and the contracts to sell the Freddie Macs (4 to 13) were all purportedly disposed of at a net long-term capital gain to Morgan of $234,732 by an assignment to RST. The assignment was

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[10] The record does not contain an explanation for the difference between this figure and the figures used on the return and the statutory notice, both of which reflect a loss of $20,621.

[11] The record does not contain an explanation for the difference between this figure and the figures used on the return and the statutory notice, both of which reflect a loss of $224,416.

1979

RMC ASSOCIATES

(Ellison C. Morgan (31.43 percent))

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 127

Contract number	*ECM buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss) (ECM share)*	
1	Buy	14.0	GNMA	9/28/79	7.5	3/10/81	79.169	C 10/09/79	76.729	($107,360)	
2	Buy	7.0	GNMA	9/28/79	8.25	3/01/81	83.281	C 10/09/79	80.744	(55,814)	
3	Buy	7.0	GNMA	9/28/79	9.0	3/30/81	86.678	C 10/09/79	83.125	(56,166)	($219,340)
4	Sell	7.0	FHLMC	9/28/79	8.75	3/15/81	84.763	A 2/12/81	72.6893	265,621	
5	Sell	7.0	FHLMC	9/28/79	9.0	4/01/81	85.178	A 2/12/81	73.1436	264,757	
6	Sell	7.0	FHLMC	9/28/79	9.25	2/15/81	86.156	A 2/12/81	74.0681	265,934	
7	Sell	7.0	FHLMC	9/28/79	9.5	3/01/81	87.125	A 2/12/81	74.9890	266,992	
8	Buy	28.0	FHLMC	10/09/79	8.0	4/15/81	79.219	A 2/12/81	69.9127	(818,954)	
9	Buy	7.0	FHLMC	10/22/79	8.75	4/15/81	78.2804	A 2/12/81	72.6893	(123,004)	
10	Buy	7.0	FHLMC	10/22/79	9.0	5/01/81	78.7205	A 2/12/81	73.1436	(122,692)	
11	Buy	7.0	FHLMC	10/22/79	9.25	3/15/81	79.6658	A 2/12/81	74.0681	(123,149)	
12	Buy	7.0	FHLMC	10/22/79	9.5	4/01/81	80.6065	A 2/12/81	74.3830	(123,585)	
13	Sell	28.0	FHLMC	10/22/79	8.0	5/15/81	75.3992	A 2/12/81	69.9127	482,812	
										A net gain =	234,732
										C + A net, net gain	15,392
										Fees	(11,031)
										Net profit to client	4,361

executed for Morgan and the other members of RMC Associates by GIM under his power of attorney.

Leinbach's account number with GGS was 137 and the transcript of the activity in his account with respect to the 1979 investment is as shown in the table on page 985.

The transcript of Leinbach's account purportedly indicates that for his deposit of $20,000 he received an initial portfolio containing forward contracts 1 to 7 (all dated October 4, 1979), of which the first three represented agreements by him to buy from GGS Ginnie Maes having a total value of $8 million, and the last four represented agreements by him to sell to GGS Freddie Macs having a total value of $8 million. Fifteen days later, on October 19, 1979, the contracts to buy Ginnie Maes were canceled by GGS at an ordinary loss for Leinbach of $389,876[12] and the contracts to sell Freddie Macs were offset by contract number 8 to buy from GGS Freddie Macs in the total amount of $8 million. On October 26, 1979, his position in the Freddie Macs were locked down by agreements to sell and to buy Freddie Macs in the amount of $8 million. On January 27, 1981, all of the Freddie Mac contracts were disposed of at a net long-term capital gain to Leinbach of $403,148 by assignment to RST. The assignment was executed for Leinbach by GIM under his power of attorney.

Brown did not participate in the program after 1979, and Morgan did not participate in the program after 1980. Transcripts of Sochin's and Leinbach's accounts for the years 1980 and 1981 as well as a transcript of Morgan's account for 1980 are set out in the tables on pages 986–992.

The deposits made by Brown, Sochin (through Harsh Associates), Morgan (through RMC Associates), and Leinbach during 1979 were refunded to them before the end of 1979. The first 49 participants in the Gregory program generally were accorded the same treatment as these petitioners. In other words, in spite of any inconsistency in their interest forecasts, these first participants each received a portfolio of contracts (many of which contained the same contracts as the portfolios received by other participants); shortly after receipt, the loss leg of each of their contract portfolios was canceled, generating the putative losses in issue; their deposits were refunded in

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[12] The record does not contain an explanation for the difference between this figure and the figures used on the return and the statutory notice, both of which reflect a loss of $394,676.

1979

JAMES N. LEINBACH AND MARY ALICE LEINBACH
GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 137

Contract number	*JNL buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss)*	
1	Buy	4.0	GNMA	10/04/79	7.5	3/10/81	78.464	C 10/19/79	73.6881	($191,036)	
2	Buy	2.0	GNMA	10/04/79	8.25	3/01/81	82.546	C 10/19/79	77.5936	(99,040)	
3	Buy	2.0	GNMA	10/04/79	9.0	3/30/81	84.943	C 10/19/79	79.9534	(99,792)	($389,876)
4	Sell	2.0	FHLMC	10/04/79	8.75	3/15/81	84.025	A 1/27/81	76.9008	142,484	
5	Sell	2.0	FHLMC	10/04/79	9.0	4/01/81	84.443	A 1/27/81	77.3399	142,062	
6	Sell	2.0	FHLMC	10/04/79	9.25	2/15/81	85.416	A 1/27/81	78.2864	142,592	
7	Sell	2.0	FHLMC	10/04/79	9.5	3/01/81	86.365	A 1/27/81	79.2286	142,728	
8	Buy	8.0	FHLMC	10/19/79	8.0	4/15/81	76.1202	A 1/27/81	74.0168	(168,272)	
9	Sell	8.0	FHLMC	10/26/79	8.0	5/15/81	74.9974	A 1/27/81	74.0168	78,448	
10	Buy	2.0	FHLMC	10/26/79	8.75	4/15/81	77.8633	A 1/27/81	76.9008	(19,250)	
11	Buy	2.0	FHLMC	10/26/79	9.0	5/01/81	78.3042	A 1/27/81	77.3399	(19,286)	
12	Buy	2.0	FHLMC	10/26/79	9.25	3/15/81	79.2472	A 1/27/81	78.2864	(19,216)	
13	Buy	2.0	FHLMC	10/26/79	9.5	4/01/81	80.1857	A 1/27/81	79.2286	(19,142)	
										A net gain =	403,148
										C + A net, net gain	13,272
										Fees	(12,660)
										Net profit to client	612

1980

JAMES E. SOCHIN

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBERS 475 AND 476

Contract number	*JES buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss) (JES share)*
14	Buy	8.0	GNMA	6/17/80	9.25	3/15/82	91.8723	A 1/26/82	67.7112	($193,289)
15	Sell	8.0	FHLMC	6/17/80	8.00	4/15/82	85.2462	C 6/20/80	86.5457	(10,396)
16	Sell	8.0	FHLMC	6/20/80	9.25	2/15/82	91.7037	A 1/26/82	66.2112	203,940
17	Sell	4.0	FHLMC	6/20/80	10.00	4/01/82	95.2781	A 1/26/82	69.1602	104,472
18	Sell	4.0	FHLMC	6/20/80	10.25	4/01/82	96.5921	A 1/26/82	70.2305	105,446
19	Buy	4.0	GNMA	6/20/80	10.50	3/01/82	99.4663	C 6/23/80	98.2301	(4,945)
20	Buy	4.0	GNMA	6/20/80	11.25	3/01/82	103.3855	C 6/23/80	102.1184	(5,068)
21	Buy	4.0	GNMA	6/23/80	10.75	5/01/82	99.4664	A 1/26/82	73.8699	(102,386)
22	Buy	4.0	GNMA	6/23/80	11.00	5/01/82	100.7626	A 1/26/82	74.9386	(103,296)
23	Buy	4.0	FHLMC	6/27/80	10.00	3/01/82	91.0065	A 1/26/82	69.1915	(87,260)
24	Buy	4.0	FHLMC	6/27/80	10.25	3/04/82	92.2827	A 1/26/82	78.2618	(88,084)
25	Sell	4.0	GNMA	6/27/80	10.75	4/01/82	96.3289	A 1/26/82	73.9011	89,711
26	Sell	4.0	GNMA	6/27/80	11.00	4/01/82	97.5986	A 1/26/82	74.9698	90,515

1980

JAMES K. SOCHIN—continued

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBERS 475 AND 476

Contract number	*JES buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Modified settle date*	*Modified settle price*	*Disposition date*	*Disposition price*	*Gain/(loss) (JES share)*
27	Buy	4.8	GNMA	6/18/80	9.25	3/15/82	91.1182	N/A	N/A	C 6/25/80	90.5797	($5,385)
28	Sell	4.8	FHLMC	6/18/80	8.00	4/15/82	84.5104	8/15/83	84.7710	A 1/26/82	59.4013	253,696
29	Buy	4.8	GNMA	6/25/80	8.00	5/15/82	84.9850	9/15/83	85.2768	A 1/26/82	60.4325	(248,443)
30	Sell	2.4	FHLMC	6/25/80	10.00	4/01/82	92.5946	N/A	N/A	C 6/26/80	92.9634	(1,844)
31	Sell	2.4	FHLMC	6/25/80	10.25	4/01/82	93.8851	N/A	N/A	C 6/26/80	94.2571	(1,860)
32	Buy	2.4	GNMA	6/25/80	10.50	3/01/82	96.7360	7/01/83	96.9953	A 1/26/82	72.2121	(123,916)
33	Buy	2.4	GNMA	6/25/80	11.25	3/01/82	100.5866	7/01/83	100.8563	A 1/26/82	75.9531	(124,516)
34	Sell	2.4	FHLMC	6/26/80	10.50	2/01/82	96.1113	6/01/83	96.3394	A 1/26/82	71.1809	125,792
35	Sell	2.4	FHLMC	6/26/80	11.25	2/01/82	99.9714	6/01/83	100.2099	A 1/26/82	74.9219	126,440
36	Sell	4.8	FHLMC	6/26/80	10.75	4/10/82	96.8381	8/10/83	97.1323	A 1/26/82	71.9106	252,216
37	Buy	4.8	GNMA	6/26/80	11.50	3/10/82	102.2525	N/A	N/A	C 6/27/80	100.5140	(17,385)
38	Buy	4.8	GNMA	6/27/80	10.75	5/10/82	96.1418	9/10/83	96.4672	A 1/26/82	72.9418	(235,254)
39	Sell	4.8	FHLMC	6/27/80	11.00	4/20/82	96.4144	8/20/83	96.7120	A 1/26/82	73.1434	235,685
40	Buy	4.8	GNMA	6/27/80	11.75	3/20/82	101.7782	7/20/83	102.0553	A 1/26/82	78.4774	(234,779)
41	Buy	4.8	GNMA	6/30/80	11.00	5/20/82	96.2725	9/20/83	96.6013	A 1/26/82	74.1746	(224,267)
42	Sell	4.8	FHLMC	6/30/80	11.75	2/20/82	99.6082	6/20/83	99.8541	A 1/26/82	77.4462	224,079
											A net gain =	45,502
											C + A net	(1,381)
											Fees	(3,092)
											Net to client	(4,473)

1981

JAMES E. SOCHIN

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 1293

Contract number	JES buy/sell	Amount	Type	Trade date	Percent	Settle date	Settle price	Disposition date	Disposition price	Gain/(loss) (JES share)
43	Sell	2.5	FHLMC	3/31/81	8.25	4/01/83	72.1670	A 1/28/83	78.2089	($48,335)
44	Sell	2.5	FHLMC	3/31/81	8.50	4/01/83	73.1076	A 1/28/83	79.4524	(50,758)
45	Buy	2.5	GNMA	3/31/81	9.00	3/01/83	76.0284	C 4/02/81	75.5986	(3,438)
46	Buy	2.5	GNMA	3/31/81	10.50	3/01/83	82.5329	C 4/02/81	82.0815	(3,611)
47	Buy	2.5	FHLMC	4/02/81	8.25	5/01/83	72.2407	A 1/28/83	78.7089	51,746
48	Buy	2.5	FHLMC	4/02/81	8.50	5/01/83	73.1787	A 1/28/83	79.9524	54,189
49	Buy	2.5	FHLMC	4/08/81	9.00	3/01/83	73.2064	P 4/09/81	73.6015	3,161
50	Buy	2.5	FHLMC	4/08/81	9.25	3/01/83	74.1241	P 4/09/81	74.5214	3,179
51	Sell	2.5	GNMA	4/08/81	9.50	4/01/83	75.5695	P 4/09/81	75.9691	(3,197)
52	Sell	2.5	GNMA	4/08/81	10.50	4/01/83	80.1516	P 4/09/81	80.5668	(3,322)
53	Sell	2.5	GNMA	4/09/81	7.50	3/10/83	68.2401	A 1/28/83	75.5144	(58,194)
54	Sell	1.25	GNMA	4/09/81	8.25	3/20/83	71.9577	A 1/28/83	79.2401	(29,130)
55	Sell	1.25	GNMA	4/09/81	9.00	3/30/83	74.2777	A 1/28/83	83.0259	(34,993)
56	Buy	1.25	FHLMC	4/09/81	8.75	3/15/83	73.2898	C 4/10/81	72.2486	(4,165)
57	Buy	1.25	FHLMC	4/09/81	9.00	4/05/83	73.7465	C 4/10/81	72.7088	(4,151)
58	Buy	1.25	FHLMC	4/09/81	9.25	2/15/83	74.6672	C 4/10/81	73.6237	(4,174)
59	Buy	1.25	FHLMC	4/09/81	9.50	3/01/83	75.5843	C 4/10/81	74.5350	(4,197)
60	Buy	2.5	GNMA	4/10/81	7.50	4/10/83	67.7494	A 1/28/83	76.0144	66,120
61	Buy	1.25	GNMA	4/10/81	8.25	4/20/83	71.4289	A 1/28/83	79.7401	33,245
62	Buy	1.25	GNMA	4/10/81	9.00	4/30/83	73.7400	A 1/28/83	83.5259	39,143
63	Buy	5.0	FHLMC	4/10/81	8.00	4/08/83	69.0184	A 1/28/83	77.4660	135,162
64	Sell	5.0	GNMA	4/10/81	9.25	3/08/83	74.1549	C 4/13/81	75.0152	(13,768)
65	Sell	5.0	FHLMC	4/13/81	8.00	2/08/83	69.3536	A 1/28/83	76.9660	(121,798)

A net gain = $36,397

C + A + P net (1,283)

Fees (2,739)

Net to client (4,022)

1980

JAMES N. LEINBACH AND MARY ALICE LEINBACH

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 137

Contract number	JNL buy/sell	Amount	Type	Trade date	Percent	Settle date	Settle price	Disposition date	Disposition price	Gain/(loss)	
14	Sell	12.0	FHLMC	6/19/80	8.0	4/15/82	85.7763	A 1/25/82	62.0353	$2,848,920	
15	Buy	12.0	GNMA	6/19/80	9.25	3/15/82	92.4154	C 6/25/80	90.5797	(220,284)	
16	Buy	12.0	GNMA	6/25/80	8.0	5/15/82	85.4850	A 1/25/82	63.5353	(2,633,964)	
17	Sell	6.0	FHLMC	6/25/80	10.0	4/01/82	92.5946	C 6/26/80	93.2964	(42,108)	
18	Sell	6.0	FHLMC	6/25/80	10.25	4/01/82	93.8851	C 6/26/80	94.5931	(42,480)	
19	Buy	6.0	GNMA	6/25/80	10.50	3/01/82	96.7360	A 1/25/82	73.1644	(1,414,296)	
20	Buy	6.0	GNMA	6/25/80	11.25	3/01/82	100.5866	C 12/11/80	86.4730	(169,363)	
								A 1/25/82	76.3791	(1,161,960)	
21	Sell	6.0	FHLMC	6/26/80	9.50	2/01/82	90.7602	A 1/25/82	67.3718	1,403,304	
22	Sell	6.0	FHLMC	6/26/80	10.75	2/01/82	97.2423	A 1/25/82	72.7368	1,470,330	
23	Sell	6.0	GNMA	6/27/80	10.50	4/01/82	95.6225	A 1/25/82	73.1331	1,349,364	
24	Sell	6.0	GNMA	6/27/80	11.25	4/01/82	99.4456	A 1/25/82	76.3478	1,385,868	
25	Buy	6.0	FHLMC	6/27/80	9.50	3/01/82	88.9952	A 1/25/82	67.3406	(1,299,276)	
26	Buy	6.0	FHLMC	6/27/80	10.75	3/01/82	95.3994	A 1/25/82	72.7056	(1,361,628)	
27	Buy	1.2	GNMA	12/12/80	11.25	2/01/82	86.5043	A 1/25/82	76.4103	(121,128)	
										A net gain	= $465,534
										C + A net	(8,701)
										Fees	(20,380)
										Net to client	(29,081

1981

JAMES N. LEINBACH AND MARY ALICE LEINBACH

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 137

Contract number	*JNL buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss)*
28	Sell	8.0	FHLMC	3/18/81	8.25	4/01/83	74.9370	A 1/07/83	79.1865	($339,960)
29	Sell	8.0	FHLMC	3/18/81	8.50	4/01/83	75.8937	A 1/07/83	80.4400	(363,704)
30	Buy	8.0	GNMA	3/18/81	9.00	3/01/83	78.8198	C 3/20/81	77.6006	(97,536)
31	Buy	8.0	GNMA	3/18/81	10.50	3/01/83	85.4630	C 3/20/81	84.1835	(102,360)
32	Buy	8.0	FHLMC	3/20/81	8.25	5/01/83	74.2269	A 1/07/83	79.6865	436,768
33	Buy	8.0	FHLMC	3/20/81	8.50	5/01/83	75.1765	A 1/07/83	88.9400	461,080
34	Buy	8.0	GNMA	3/26/81	7.50	3/10/83	69.3202	A 1/07/83	76.9090	607,104
35	Buy	4.0	GNMA	3/26/81	8.25	3/20/83	73.0601	A 1/07/83	80.7177	306,304
36	Buy	4.0	GNMA	3/26/81	9.00	3/30/83	75.3850	A 1/07/83	84.5343	365,972
37	Sell	4.0	FHLMC	3/26/81	8.75	3/15/83	73.3992	C 3/30/81	73.8287	(17,180)
38	Sell	4.0	FHLMC	3/26/81	9.00	4/05/83	73.8538	C 3/30/81	74.2818	(17,120)
39	Sell	4.0	FHLMC	3/26/81	9.25	2/15/83	74.7779	C 3/30/81	75.2082	(17,212)
40	Sell	4.0	FHLMC	3/26/81	9.50	3/01/83	75.6984	C 3/30/81	76.1311	(17,308)
41	Sell	8.0	GNMA	3/30/81	7.50	4/10/83	69.2290	A 1/07/83	76.4090	(574,400)
42	Sell	4.0	GNMA	3/30/81	8.25	4/20/83	72.9846	A 1/07/83	80.2177	(289,324)
43	Sell	4.0	GNMA	3/30/81	9.00	4/30/83	75.3130	A 1/07/83	84.0343	(348,852)
44	Buy	8.0	GNMA	3/30/81	9.50	3/01/83	77.6285	P 4/02/81	77.4455	(14,640)

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1981

JAMES N. LEINBACH AND MARY ALICE LEINBACH—continued

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 137

Contract number	*JNL buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss)*	
45	Buy	8.0	GNMA	3/30/81	10.50	3/01/83	82.2716	P 4/02/81	82.0815	($15,208)	
46	Sell	8.0	FHLMC	3/30/81	9.00	4/01/83	74.2484	P 4/02/81	74.0674	14,480	
47	Sell	8.0	FHLMC	3/30/81	9.25	4/01/83	75.1747	P 4/02/81	74.9926	14,568	
48	Buy	8.0	FHLMC	4/08/81	9.00	3/01/83	73.2064	P 4/09/81	73.6015	31,608	
49	Buy	8.0	FHLMC	4/08/81	9.25	3/01/83	74.1241	P 4/09/81	74.5214	31,784	
50	Sell	8.0	GNMA	4/08/81	9.50	4/01/83	75.5695	P 4/09/81	75.5691	(31,968)	
51	Sell	8.0	GNMA	4/08/81	10.50	4/01/83	80.1516	P 4/09/81	80.5668	(33,216)	
52	Sell	16.0	GNMA	4/10/81	9.25	3/08/83	74.1549	A 1/07/83	85.0065	(1,736,256)	
53	Buy	16.0	FHLMC	4/10/81	8.00	4/08/83	69.0184	C 4/13/81	68.2503	(122,896)	
54	Buy	16.0	GNMA	4/13/81	9.25	2/04/83	73.8634	A 1/07/83	85.5065	1,862,896	
55	Buy	8.0	FHLMC	4/13/81	9.00	3/01/83	71.9218	P 4/14/81	73.3502	114,272	
56	Buy	8.0	FHLMC	4/13/81	9.25	3/01/83	72.8322	P 4/14/81	74.2687	114,920	
57	Sell	8.0	GNMA	4/13/81	9.50	4/01/83	74.2704	P 4/14/81	75.7149	(115,560)	
58	Sell	8.0	GNMA	4/13/81	10.50	4/01/83	78.8013	P 4/14/81	80.3027	(120,112)	
										A net gain =	$387,628
										C + A + P net	(13,056)
										Fees	(28,660)
										Net to client	(41,716)

1980

ELLISON C. MORGAN

GREGORY GOVERNMENT SECURITIES ACCOUNT NUMBER 127

Contract number	*ECM buy/sell*	*Amount*	*Type*	*Trade date*	*Percent*	*Settle date*	*Settle price*	*Disposition date*	*Disposition price*	*Gain/(loss) (ECM share)*	
14	Sell	15.0	FHLMC	6/17/80	8.00	4/15/82	85.5625	C 6/20/80	86.5457	($147,480)	
15	Buy	15.0	GNMA	6/17/80	9.25	3/15/82	92.1964	A 2/08/82	65.2136	(4,047,420)	
16	Sell	15.0	FHLMC	6/20/80	9.25	2/15/82	91.7037	A 2/08/82	63.7136	4,198,515	
17	Sell	7.5	FHLMC	6/20/80	10.00	4/01/82	95.2781	A 2/08/82	66.9439	2,125,065	
18	Sell	7.5	FHLMC	6/20/80	10.25	4/01/82	96.5921	A 2/08/82	68.1494	2,133,202	
19	Buy	7.5	GNMA	6/20/80	10.50	3/01/82	99.4663	C 6/23/80	97.8938	(117,937)	
20	Buy	7.5	GNMA	6/20/80	11.25	3/01/82	103.3855	C 6/23/80	101.7737	(120,885)	
21	Buy	7.5	GNMA	6/23/80	10.75	5/01/82	99.1273	A 2/08/82	72.0709	(2,029,230)	
22	Buy	7.5	GNMA	6/23/80	11.00	5/01/82	100.4206	A 2/08/82	73.2864	(2,035,065)	
23	Buy	7.5	GNMA	6/27/80	10.00	3/01/82	92.3731	A 2/08/82	68.0064	(1,827,502)	
24	Buy	7.5	GNMA	6/27/80	10.25	3/01/82	93.6522	A 2/08/82	69.2119	(1,833,022)	
25	Sell	7.5	FHLMC	6/27/80	10.75	4/01/82	95.6418	A 2/08/82	71.0709	1,842,817	
26	Sell	7.5	FHLMC	6/27/80	11.00	4/01/82	96.9144	A 2/08/82	72.2864	1,847,100	
										A net gain	= $374,460
										C + A net	(11,842)
										Fees	(13,900)
										Net to client	(25,742)

full; their gain legs (which were locked in) were carried on GGS' books for a period generally exceeding 16 months; and then their gain legs were assigned, which generated a credit to each participant's account that was set off against the loss (debit) generated by the earlier cancellation. Those participants who followed with GGS accounts numbered 150 and after were accorded the same treatment as the first participants except that they did not receive refunds of their deposits.[13] The refunds given by Gregory to the first 49 participants obviously served as some inducement to others to participate in his program.

All assignments made during 1980 and through November 1981 were to RST, a partnership whose members, Campbell Richardson, Stephen Shepard, and David Tangvald, were associates of Gregory. The assignments made thereafter were to Northwest Investment Group, Inc. (NIG), a Nevada corporation of which Patricia Buescher, a niece of Mr. Gregory and an employee of GGS, was the principal stockholder and officer. Lyle Adams, another employee of GGS, was also an officer of NIG. GGS mailed the assignment documents to NIG at a mail drop established by NIG in Nevada; the documents were forwarded from there to Adams at his Portland residence.

GGS paid RST and NIG $100 for each assignment without regard to the amount of the contract. The assignment fee in each case was charged to the participant's account. The contracts were subsequently reassigned by RST and NIG to GGS at the same price as that used in the original assignment by the participant. As a result, neither RST nor NIG realized any income from the acquisition or the disposition of the contracts. In this connection, their income was limited to the $100 fees paid by GGS and charged to the participants. Furthermore, both the assignments to RST and NIG, as well as the reassignments by them to GGS, were handled by offsetting accounting entries of receivables and payables. In other words, other than the assignment fees for $100, no funds were exchanged with respect to the contracts at any time between the participants and RST or NIG on the original assignment or between RST or NIG and GGS on the reassignments.

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[13] In or about November of 1979, full refunds of deposits ceased.

After the reassignment of an investor's contracts by RST or NIG to GGS, the payable due from the investor as a result of the cancellation of his loss position was due to GGS. At the same time, the receivable in approximately the same amount due the investor as a result of the assignment of his gain position was due from GGS. At this point, the circle was completed and neither the investor, nor his assignee on the gain position (RST or NIG), nor GGS had realized any actual gain or loss on the contracts. The relatively minor net profits or net losses reflected by some of the transcripts of its accounts with petitioners were generated by GGS through "adjustments" to the cancellation prices and/or the assignment prices or, at times, by the failure of GGS to charge full transaction fees in accordance with the client agreements.

No Ginnie Maes or Freddie Macs were ever bought or sold with respect to any of the forward contracts to buy or sell such securities executed by GGS as one party, and executed by or for petitioners Brown, Sochin, Morgan, or Leinbach as the other party. In fact, the record does not contain any evidence that any Ginnie Maes or any Freddie Macs were ever bought, sold, accepted, or delivered under any forward contract executed by GGS with any investor during the years 1979, 1980, and 1981.[14] Instead, all loss positions were canceled before settlement dates and all gain positions were assigned to RST or NIG and reassigned to GGS before such dates. Apparently GGS also never had any inventory of either Ginnie Maes or Freddie Macs because, as Gregory testified, if GGS had ever been called upon for delivery it would have had to go into the market and try to make the necessary purchase.

In at least two instances, a Ginnie Mae described in and covered by one of the alleged forward contracts involved in this case was a rate (11.25 percent and 11.75 percent) at which no Ginnie Mae had ever been issued up to the date of trial.

The use of a cancellation to close, dispose of, or settle a forward contract is not a common practice by dealers in such contracts. For the most part, cancellations are used by such dealers only to correct errors.

Petitioner Dennis S. Brown is the sole stockholder and principal officer of an employment agency which he started in

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[14] There is some evidence that a single such transaction was entered into with respect to litigation pending in another court after 1981.

1968. Prior to his investment in Gregory Government Securities, he had speculated in interest-rate futures offered by Merrill Lynch. He learned about Mr. Gregory from his accountant in October of 1979, and shortly thereafter attended a meeting with Mr. Gregory with his accountant and several other clients of his accountant.

On or about October 4, 1979, Mr. Brown deposited $10,000 with GGS. The deposit was refunded to him before the end of 1979. He was advised that before the end of 1979 he had realized an ordinary loss from GGS in the amount of $106,160 which he deducted on his 1979 return. He understood that in 1981 he had a long-term capital gain from the assignment of the remainder of his portfolio with GGS in the amount of $106,382 which he reported on his 1981 income tax return.

In 1979, 1980, and 1981, petitioner James E. Sochin was employed by Harsh Investment Corp. as a vice president in charge of its hotel operations division. He first heard about Mr. Gregory through Harold Schnitzer, who was the owner of Harsh Investment Corp. Through a meeting arranged by Mr. Schnitzer, Mr. Sochin attended a conference with Mr. Gregory in which he explained the portfolio structure and how interest rate movements affected security prices. After this meeting and on or about September 18, 1979, Mr. Sochin contributed $2,000 toward the total $12,000 deposited with GGS by Harsh Associates; Sochin and the other Harsh Associates received full refunds of their deposits before the end of 1979. He was later advised that he had an ordinary loss in 1979 of $20,621 which he reported on his 1979 income tax return. In 1980, he was advised that he had an ordinary loss on his GGS transactions in the amount of $48,054 and a long-term capital gain in the amount of $21,142, both of which he reported on his 1980 return. In 1981, he deducted an ordinary loss in the amount of $38,785 and reported a long-term capital gain in the amount of $44,804 from his GGS transactions.

At the time of trial, Ellison C. Morgan was 47 years of age. During 1979, 1980, and 1981, he was the president of Resource Management Consultants which designs and markets executive compensation plans, places loans for savings and loan associations, and through a separate company, designs and markets life insurance products through about 50 distributors. From about 1971 through about 1982, he invested regularly and extensively in futures contracts. For example, during this period he bought, sold, and otherwise dealt in futures contracts in sugar, cattle, hopps, copper, corn, wheat, Deutsche marks, Swiss francs, bean oil, Canadian dollars, gold, treasury bills, and treasury bond. He had also dealt in Ginnie Maes and Freddie Macs.

Mr. Morgan first met Mr. Gregory while he was a partner with Arthur Andersen. They first met professionally when Mr. Gregory did some estate and financial planning for some of Mr. Morgan's clients and partners. Some time later in 1979, Mr. Morgan met on several different occasions with Mr. Gregory in order to learn about the promotion known as Gregory Government Securities. During these conversations and later conversations which he had with his own attorney, Mr. Morgan was made to understand that there was no guarantee against losses in case an investment was made in the program, and there was no guarantee of any gains. He did understand that an investment would result in a tax writeoff during the first year of approximately 10 to 1. He also understood that his initial deposit would be returned during the first year.

Mr. Morgan understood that he would simply furnish Mr. Gregory with an interest forecast and that Mr. Gregory would handle all of the necessary transactions through his two corporations. He was later advised that the transactions resulted in an ordinary loss during 1979 in the amount of $224,416, which he claimed on his 1979 income tax return. He also claimed a deduction for investment advice in the amount of $357. His deposit was also refunded to him before the end of 1979. In 1980, he was advised that he had an ordinary loss from his GGS transactions in the amount of $390,614 which he deducted on his 1980 return. On his 1981 income tax return, he reported a long-term capital gain from GGS transactions in the amount of $234,518, which he understood was the final result of his 1979 portfolio. He was later advised that he had a long-term capital gain in 1982 from his 1980 portfolio, but he did not report the 1982 gain because respondent in the meantime had audited his earlier returns and had disallowed the losses claimed therein.

Petitioner James N. Leinbach is a professional engineer, having received a composite degree in civil, electrical, and mechanical engineering from the University of Portland in 1951. Upon receipt of his engineering degree, he went to work for a construction firm by the name of Slate-Hall as an assistant engineer. In 1961 he became a partner, and by 1979 he owned 50 percent of the firm which was then known as the Fred H. Slate Co. The company is primarily engaged in the construction of highways, but builds some dams. Prior to 1979, Mr. Leinbach had made personal investments in bonds, common stocks, and preferred stocks. Some of his investments were exempt from State income tax.

In or about September of 1979, Mr. Leinbach learned of the GGS program. Shortly thereafter, he and his accountant and his partner attended a meeting with Mr. Gregory. As a result of the meeting, Mr. Leinbach understood that the program involved mortgages secured by the Government and he also understood that there were a number of advantages including the possibility of a profit and a considerable tax loss in the first year.

In 1979, he made a deposit of $20,000 with GGS. The deposit was refunded to him before the end of the year. On his income tax return for 1979, Mr. Leinbach reported income in the amount of $427,681 from his partnership and deducted a loss in the amount of $394,376 on his GGS transactions. On his 1980 income tax return, Mr. Leinbach reported income from the partnership and other sources of $536,507 and deducted an ordinary loss from GGS transactions in the amount of $482,245. On his income tax return for 1981, Mr. Leinbach reported a long-term capital gain from the GGS transactions in the amount of $401,464 and an ordinary loss from the same transactions in the amount of $401,412. On his 1982 tax return, Mr. Leinbach reported a long-term capital gain from GGS transactions in the amount of $461,444.[15]

OPINION

1. Losses on Forward Contracts

The central issue in these cases is whether the losses claimed by petitioners are bona fide or whether they are based upon an elaborate sham. Respondent contends that the losses were generated in form without any substance, that the underlying transactions were fictitious, and that such transactions existed only within the GGS computer. On the other hand, petitioners contend that the losses were genuine and were the result of bona fide transactions entered into for profit under section 165(c)(2) and are clearly allowable under section 108 of the Tax Reform Act of 1984, Pub. L. 98–369, 98 Stat. 680, or the standard laid down in *Smith v. Commissioner*, 78 T.C. 350 (1982).

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[15] An amended return was filed for 1981 and 1982 as a protective claim for refund of the reported gain because the Commissioner on audit disallowed the GGS losses previously reported.

Section 165(a) allows a deduction for a loss sustained during the taxable year that is not compensated for by insurance or otherwise. In the case of individuals, however, the deduction is limited to losses incurred in a trade or business, in a transaction entered into for profit, or as the result of a casualty or theft. Sec. 165(c). In any event, to be deductible, the claimed loss must be the result of a bona fide transaction, and substance, not mere form, shall be the determining factor. Sec. 1.165–1(b), Income Tax Regs. See *Gregory v. Helvering*, 293 U.S. 465 (1935).

Respondent's determination that the underlying transactions are not bona fide is presumptively correct; and petitioners have the burden of proof. *Welch v. Helvering*, 290 U.S. 111, 115 (1933); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934); Rule 142(a).

A careful review of the voluminous record leads us to the inescapable conclusion that petitioners have failed to establish that the transactions leading to their alleged losses were bona fide. In fact, from the record as a whole, we are satisfied that petitioners have failed to establish that the entire program from which the losses allegedly arose did not exist solely to provide tax benefits for its investors.

All of the forward contracts promoted by Mr. Gregory were between GGS, as one party, and one petitioner or some other participant, as the other party. Furthermore, each petitioner as well as all other participants executed a power of attorney which authorized GGS and/or GIM to execute and perform any act for the investor with respect to the contracts that GGS and GIM deemed expedient and at a price determined by GGS and adjusted for any reason which GGS considered appropriate. In addition, an ultimate profit obviously could be, and at times was to a nominal extent, manipulated by GGS merely by foregoing a part of the fees cited in the disclosure memorandum or by utilizing its pricing formula.

These cases are analogous to, if not factually indistinguishable from, the situation recently considered by us in *Julien v. Commissioner*, 82 T.C. 492 (1984). In *Julien v. Commissioner*, *supra*, we disallowed interest deductions on alleged indebtedness incurred to purchase silver bullion in a series of purported cash and carry silver straddles. Having found that the taxpayers never actually purchased any silver nor incurred any real indebtedness, we concluded that the underlying transaction was a factual sham and served no economic purpose beyond generating a tax deduction for interest. Commenting on the lack of risk due to the fixed nature of the straddles involved in *Julien*, we stated at page 508:

> It seems self-evident that, in any commodity straddle, a legitimate investor must have some potential of making money as a result of various market forces and, by the same token, be a[t] risk of losing money. One commentator has said that "A commodity straddle is held in the expectation of profiting from a change in the 'spread' or 'premium', the difference in price between two futures contracts. While the price movements of the two contracts will have some relationship to each other, as the prices will be affected by similar economic conditions, neither in theory nor in practice are the fluctuations identical." See R. Dailey, "Commodity Straddles in Retrospect: Federal Income Tax Considerations," 47 Brooklyn L. Rev. 321 (Winter, 1981). Presumably, fluctuations would also occur in a case where the investor holds silver bullion against a forward contract, if the end result were not, as here, prearranged.

In *Falsetti v. Commissioner*, 85 T.C. 332 (1985), we found that an alleged sale was a "sham in substance" which we defined as being "the expedient of drawing up papers to characterize transactions contrary to objective economic realities and which have no economic significance beyond expected tax benefits."

The facts before us are also somewhat similar to those described in *United States v. Winograd*, 656 F.2d 279, 281 (7th Cir. 1981), affirming defendant's conviction under section 7206(2) of conspiring to impair the collection of income taxes by claiming losses on tax straddles in futures contracts in Mexican pesos which were not entered into through bona fide trades or open bids on an established market but instead were prearranged, uncompetitive trades between various employees of one of the principals involved. See also *United States v. Turkish*, 623 F.2d 769 (2d Cir. 1980); *United States v. Siegel*, 472 F. Supp. 440 (N.D. Ill. 1979). The conclusion that the disputed transactions in the cases before us are not bona fide is even more appropriate in view of our finding that GGS was not only a party to each of the forward contracts but also in most instances executed, canceled, and assigned the contracts under powers of attorney for the other parties. Furthermore, the contracts were executed, canceled, and assigned at prices determined solely by GGS, and the only third parties to any of the transactions (RST and NIG) were closely associated with Mr. Gregory through business or otherwise.

We conclude, therefore, that the losses claimed by petitioners are not allowable because the disputed transactions constituted factual shams which were inspired, designed, and executed by Mr. Gregory and the two corporations controlled by him for the sole purpose of attempting to achieve tax losses for their investors.[16]

This conclusion is not altered by our decision in *Smith v. Commissioner*, *supra*, or by section 108 of the Tax Reform Act of 1984, because they do not apply to alleged straddles which are in fact fake or fictitious. *Miller v. Commissioner*, 84 T.C. 827 (1985); *Forseth v. Commissioner*, 85 T.C. 127 (1985); *Magin v. Commissioner*, T.C. Memo. 1985-304.

2. *Fees Paid With Respect to Forward Contracts*

Fees paid by petitioners to GGS were paid so that they could participate in Gregory's program. Inasmuch as we have found that the program was operated solely to provide tax deductions for its participants, the fees constituted payments to purchase such deductions and as such are, at best, personal expenditures which are not deductible under section 162 or section 212. *Zmuda v. Commissioner*, 79 T.C. 714 (1982), affd. 731 F.2d 1417 (9th Cir. 1984); *Houchins v. Commissioner*, 79 T.C. 570 (1982). See also *Falsetti v. Commissioner*, 85 T.C. 332 (1985).

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[16] In view of our finding with respect to the sham issue, we need not consider the other contentions advanced by respondent with respect to the losses.

3. Additions to Tax Under Section 6653(a)

Respondent determined that an addition to tax is due from petitioners Ellison C. and Linda Morgan for negligence under section 6653(a). In view of our finding hereinbefore that the underlying transactions were in fact shams, and in view of our subsequent finding that petitioner Ellison C. Morgan knew or should have known at the time that they were shams, it is apparent that he ignored applicable law and regulations in the preparation of his returns. Consequently, respondent's determination that additions to tax are due from Ellison C. Morgan under section 6653(a) is sustained.

4. Damages Under Section 6673

Finally, we turn to respondent's request that damages be imposed against petitioners in each of these cases under section 6673. With respect to this issue and from the record as a whole, we are satisfied that, in spite of their protestations to the contrary, petitioners Dennis S. Brown, James E. Sochin, Ellison C. Morgan, and James N. Leinbach were mature, well-educated, and well-read individuals who were sufficiently knowledgeable and sophisticated with respect to business and tax matters to have known, and actually did know, at the time the disputed transactions were entered into, that the transactions were "too good" to be real and therefore were shams. However, transactions involving forward contracts and especially forward contracts entered into with respect to Ginnie Maes and Freddie Macs are extremely complicated and, during the years under consideration, were relatively new. Furthermore, from the time the petitions were filed in these cases up to and after the date of trial, the law with respect to tax straddles was uncertain. See *Miller v. Commissioner*, 84 T.C. 827 (1985); *Forseth v. Commissioner*, 85 T.C. 127 (1985); and *Julien v. Commissioner*, 82 T.C. 492 (1984). Consequently, we are reluctant to conclude that petitioners were also aware that tax claims stemming from their transactions with Gregory and his associates might constitute a basis for the imposition of damages under section 6673, although the Supreme Court had held for many years that claims based upon unreal and sham transactions were not recognizable for tax purposes. See *Gregory v. Helvering*, 293 U.S. 465 (1935);

Higgins v. Smith, 308 U.S. 473 (1940); and *Knetsch v. Commissioner*, 364 U.S. 361 (1960), affg. 272 F.2d 200 (9th Cir. 1959). We hereby serve notice, however, that henceforth we will have no such reluctance with respect to petitioners who file petitions or maintain positions based upon transactions which they knew or reasonably should have known to be factual shams.

We feel that such action is warranted because Congress is concerned with the substantial increase in the number of petitions pending before the Tax Court and especially those petitions based upon frivolous or groundless claims. The concern of Congress in this connection is apparent from the Conference report on the consideration of section 6621(d)(4) dealing with increased interest on substantial underpayments attributable to tax motivated transactions. There it is stated:

> The conferees note that a number of the provisions of recent legislation have been designed, in whole or in part, to deal with the Tax Court backlog. Examples of these provisions are the increased damages assessable for instituting or maintaining Tax Court proceedings primarily for delay or that are frivolous or groundless (sec. 6673), the adjustment of interest rates (sec. 6621), the valuation overstatement and substantial understatement penalties (secs. 6659 and 6661), and the tax straddle rules (secs. 1092 and 1256).
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> * * *
>
> The conferees believe that, with this amendment, the Congress has given the Tax Court sufficient tools to manage its docket, and that the responsibility for effectively managing that docket and reducing the backlog now lies with the Tax Court. The positive response that the Court has made to several recent GAO recommendations is encouraging and the conferees expect the Court to implement swiftly these and other appropriate management initiatives. The conferees also note favorably the steps the Court has begun to take in consolidating similar tax shelter cases and dispensing with lengthy opinions in routine tax protester cases. The Court should take further action in these two areas, as well as to assert, without hesitancy in appropriate instances, the penalties that the Congress has provided.
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> [H. Rept. 98–861 (Conf.) (1984), 1984–3 C.B. (Vol. 2) 1, 239.]

Our own concern for the continuing increase in the number of petitions based upon frivolous or groundless claims has been clearly expressed in such opinions as *Sydnes v. Commissioner*, 74 T.C. 864, 872 (1980), where we stated:

> While in the past we have been reluctant to impose damages in cases involving persons other than those who were merely protesting the Federal tax laws, we think the imposition of damages in the circumstances here is fully warranted. Moreover, since the statute does not restrict us to those

cases in which a party has requested us to impose damages, we think we should do so, on our own motion, where the facts and circumstances so dictate.

Here, the Court and respondent have been required to consider the same issue twice after it had already been decided by this Court and affirmed by the Court of Appeals. Petitioners with more genuine controversies have been delayed while we considered these cases involving the same issue. In these circumstances, the petitioner, an accountant with some knowledge of the Federal tax laws, cannot and has not shown that he, in good faith, has a colorable claim to challenge the Commissioner's determination. Indeed, he knew when he filed the present case with this Court that he had no reasonable expectation of receiving a favorable decision. No reasonably prudent person could have expected this Court to reverse itself in this situation.

In *Oneal v. Commissioner*, 84 T.C. 1235, 1243–1244 (1985), we warned such petitioners as follows:

> We have frequently found that cases based upon meritless contentions and stale arguments are burdensome both on this Court and upon society as a whole. See *Abrams v. Commissioner*, 82 T.C. 403 (1984). The time spent upon this case has delayed other cases of merit which could have provided new precedents to the tax system. Petitioners' brief, much like their abusive tax shelter "investment," was merely a prepackaged, pro forma presentation.
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> Upon review of this record, we find that petitioners' positions are frivolous and groundless and that this proceeding was instituted and maintained primarily for delay. We admonish other petitioners and their counsel not to maintain frivolous proceedings before this Court or to maintain them primarily for delay.

Again, in *Abrams v. Commissioner*, 82 T.C. 403, 411–412 (1984),[17] we summed up the situation in the following manner:

> The Court of Appeals for the Ninth Circuit has, in a summary and decisive manner, awarded double costs in several tax protester cases on its own motion. On July 7, 1982, in *Edwards v. Commissioner*, 680 F.2d 1268, 1271 (9th Cir. 1982), affg. per curiam an unreported decision of this Court, the Court said—
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> "Meritless appeals of this nature are becoming increasingly burdensome on the federal court system. *We find this appeal frivolous.* Fed. R. App. P. 38, and accordingly award double costs to appellee [the Commissioner of Internal Revenue]. * * * [Citations omitted; emphasis added in 82 T.C.]"
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> Accord *McCoy v. Commissioner*, 696 F.2d 1234 (9th Cir. 1983), affg. 76 T.C. 1027 (1981); *Barmakian v. Commissioner*, 698 F.2d 1228 (9th Cir. 1982), affg.

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[17] See also *Stafford v. Commissioner*, T.C. Memo. 1983-650, and *Vickers v. Commissioner*, T.C. Memo. 1983-429.

> without published opinion an unreported order and decision of this Court; *Martindale v. Commissioner*, 692 F.2d 764 (9th Cir. 1982), affg. without published opinion an unreported order and decision of this Court.
>
> It is now certain that all Courts will no longer tolerate the filing of frivolous appeals. On June 13, 1983, the Supreme Court, for the first time, invoked the provisions of its rule 49.2, which the Court adopted in 1980, and ordered an appellant to pay damages for bringing a frivolous appeal. In *Tatum, Elmo C. v. Regents of Nebraska-Lincoln* (No. 82-6145), the Court issued the following order: "The motion of respondents for damages is granted and damages are awarded to respondents in the amount of $500.00 pursuant to Supreme Court Rule 49.2."
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> The direction of this nation's highest court is crystal clear—that no court should permit frivolous or groundless appeals, not only in discrimination suits but in any other area of litigation, including Federal income taxation. The language of amended section 6673 is equally clear.
>
> [Fn. refs. omitted.]

Finally, in *Elliott v. Commissioner*, 84 T.C. 227, 248 (1985), we stated that "At some point, the arguments in these highly leveraged tax avoidance (or evasion) schemes must be regarded as 'frivolous or groundless,' [under] section 6673."[18]

Even though the positions maintained by petitioners in these cases may be frivolous and groundless, we decline to impose damages as provided by section 6673 against these petitioners because prior to the publication of this opinion they were not aware that we would consider doing so in factual situations such as theirs. This is not to be construed, however, as any indication that specific notice is required before damages are imposed in a future case because, as held in *Abrams v. Commissioner*, 82 T.C. 403 (1984), in a proper case we can and will impose such damages even on our own motion.

Decisions will be entered under Rule 155.

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[18] See also *Snyder v. Commissioner*, T.C. Memo. 1985-9, where we concluded, "it is apparent from the overall record * * * that petitioner was a party to an abusive tax shelter. This type of arrangement disparages good tax planning and denigrates both the Congressional purpose inherent in the credits and deductions which we here disallow and our national tax system. Petitioner knew, or reasonably should have known, this when he agreed to participate in this specious stratagem of tax illusion. Petitioner, and those like him, who exchange small cash amounts for large tax deductions because of pie-in-the-sky nonrecourse transactions arranged to jack up basis without underlying economic substance or entrepreneurial risk may become subject to consequences unanticipated by the parties. See *Barnard v. Commissioner*, 731 F.2d 230 (4th Cir. 1984), affg. *Fox v. Commissioner*, 80 T.C. 972 (1983)."

Reviewed by the Court.

STERRETT, SIMPSON, GOFFE, CHABOT, NIMS, PARKER, WHITAKER, KÖRNER, HAMBLEN, COHEN, CLAPP, JACOBS, WRIGHT, PARR, and WILLIAMS, *JJ.*, agree with this opinion.

WILBUR, *J.*, concurs in the result only.

SWIFT and GERBER, *JJ.*, did not participate in the consideration of this case.

J. A. TOBIN CONSTRUCTION COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 10063–82. Filed December 18, 1985.

The availability of loss carryforwards and loss carrybacks of members of an affiliated group to offset separate income of other members of the affiliated group determined. Respondent's adjustment under sec. 482, I.R.C. 1954, for imputed interest income rejected.

Richard S. Managhan and *Ernest M. Fleischer*, for the petitioner.

Alan V. Jacobson, for the respondent.

SWIFT, *Judge*: Respondent determined a deficiency in petitioner's Federal income tax liability for the year 1975 in the amount of $306,958.67. The parties have reached a partial settlement and the remaining issues for the Court to decide concern the loss carryback and loss carryforward rules of the consolidated return regulations and the validity of certain adjustments made under section 482[1] for imputed interest income.

Although the tax deficiency involved herein pertains only to the Federal corporate income tax liability of J.A. Tobin Construction Co., Inc. (Tobin Construction) for 1975, the issues in this case arise out of certain corporate reorganizations involving Tobin Construction and three affiliated corporations which occurred in 1975, 1976, and 1977, and the extent to which loss carrybacks and loss carryforwards of the affiliated corporations are available to reduce Tobin Construction's taxable income for 1975. Similarly, our decision on the section 482 issue, which directly involves 1977 and 1978, will affect the amount of net operating losses that will be available as a carryback to offset Tobin Construction's 1975 taxable income.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as in effect during the year in issue.

FINDINGS OF FACT

Some of the facts were stipulated and are so found.

Tobin Construction timely filed its Federal corporate income tax return for 1975. Tobin Construction was a Missouri corporation doing business in Kansas and Missouri at the time it filed its petition herein. Its corporate headquarters were located in Kansas City, Kansas.

Tobin Construction was formed in 1928 as a closely held, family owned construction company. In 1974 and for a number of years prior thereto, Joseph Tobin (Joseph) and his sister Patricia A. O'Rourke (Patricia) each owned 50 percent of the stock of Tobin Construction.

Rosedale Development Co., Inc. (Rosedale) also was a construction and real estate development company owned by members of the Tobin family. Rosedale was incorporated on May 2, 1924, and in 1974 the stock of Rosedale was owned 30 percent by Patricia and 70 percent by her mother, Mrs. F.M. Tobin.

In 1975, Patricia initiated negotiations with Joseph concerning the ownership and operations of Tobin Construction that might lead to her children's becoming involved with the management of the company. As a result of the negotiations, Joseph agreed to sell his entire stock interest in Tobin Construction to a corporation wholly owned by Patricia.

To accomplish her indirect acquisition of Joseph's stock in Tobin Construction, Patricia, on the advice of her attorneys, utilized a corporation by the name of Three Central United, Inc. (Three Central). On December 9, 1975, Patricia exchanged her 50-percent stock interest in Tobin Construction for all of the common stock of Three Central. On the same day, Three Central purchased all of Joseph's stock in Tobin Construction for $2.9 million in cash. As a result of those two transactions, Patricia became the sole shareholder of Three Central, and Three Central became the sole shareholder and parent of

Tobin Construction. On December 17, 1975, the name of Three Central was changed to O'Rourke Bros.

The corporate history of Three Central (i.e., O'Rourke Bros.) prior to its utilization to acquire the stock of Tobin Construction is important in this case. Prior to late 1975, Three Central had been a "shelf" corporation. It was incorporated by a Kansas City law firm on July 15, 1974, as a Missouri corporation. Members of the law firm were designated as the shareholders, officers, and directors of Three Central solely to comply with Missouri corporation law. No business was conducted by Three Central, and its corporate status simply was maintained by the law firm in good standing until and if a client of the law firm needed a new corporate vehicle for the transaction of business being handled by the law firm. Three Central had conducted no economic activity and had total assets of $1.

As mentioned, in December of 1975, Three Central was utilized by Patricia to acquire all of her stock and all of Joseph's stock in Tobin Construction. To make Three Central a suitable corporate vehicle for the acquisition of Tobin Construction, a number of changes were necessary in its corporate structure shortly prior to the contemplated stock acquisition. On November 19, 1975, Three Central applied to the State of Missouri to change its name to O'Rourke Bros, Inc. It opened a bank account and applied for a bank loan of $2.9 million in order to fund the purchase of Joseph's stock in Tobin Construction.

On November 28, 1975, the three outstanding shares of common stock of Three Central were redeemed, and 100 shares of common stock were issued to Patricia in exchange for all of her stock in Tobin Construction. A new board of directors was elected, and Patricia and members of her family were elected to the board. Patricia also was elected president and treasurer of the corporation. As mentioned, the name of Three Central was changed to O'Rourke Bros., Inc. (O'Rourke), on December 17, 1975.

On December 31, 1975, O'Rourke declared a stock dividend pursuant to which Patricia received 4 shares of common stock for each share she owned. Thus, on December 31, 1975, Patricia was the sole shareholder of O'Rourke with 500 shares of its common stock, and O'Rourke was the sole shareholder of Tobin Construction.

On March 9, 1976, there was filed on behalf of O'Rourke and Tobin Construction a joint application for an automatic extension of time to file a consolidated Federal corporate income tax return for 1975. On June 14, 1976, however, there was filed on behalf of O'Rourke and Tobin Construction, separate Federal corporate income tax returns for 1975. On Tobin Construction's 1975 return, the statement was made that, "Taxpayer and its parent subsequently decided against filing a consolidated Federal income tax return for 1975." That decision apparently was made because petitioner's representatives thought that the filing of a consolidated return for 1975 would have required the preparation of a separate return for Tobin Construction for the period January 1, 1975, to December 8, 1975, due to the acquisition of Tobin Construction on December 9, 1975. Since O'Rourke realized a net operating loss for 1975 of only $13,918, which could be carried forward to 1976, the representatives of O'Rourke and Tobin Construction decided against filing a consolidated return for 1975.

On its 1975 separate corporate Federal income tax return, Tobin Construction reflected taxable income of $1,869,307. Rosedale, on its 1975 separate corporate Federal income tax return, reflected a net operating loss of $171,730.

In 1976, O'Rourke acquired ownership of two additional corporations, P.M. Divide Mining Co. (Divide) and Rosedale. Divide was incorporated on June 3, 1976, as a Missouri corporation to engage in a coal mining venture. On June 27, 1976, O'Rourke acquired all 125 shares of the common stock of Divide for the total amount of $125.

On December 31, 1976, O'Rourke acquired all of the stock of Rosedale by exchanging 81 shares of the common stock of O'Rourke for all of the outstanding shares of Rosedale owned by Patricia and by exchanging 13,000 shares of preferred stock of Rosedale for all of the outstanding stock of Rosedale owned by Mrs. F.M. Tobin.

For 1976, Tobin Construction, O'Rourke, and Divide filed a consolidated Federal corporate income tax return and reflected thereon the following separate income and loss figures and consolidated taxable income as indicated:

	1976 *Taxable income or loss*
Tobin Construction	$1,564,588
O'Rourke	(244,003)
Divide	0
1976 Consolidated taxable income	1,320,585

Rosedale filed a separate Federal corporate income tax return for 1976, reflecting a taxable income of $79,929.

For 1977 and 1978, Tobin Construction, O'Rourke, Divide, and Rosedale filed consolidated Federal corporate income tax returns reflecting the following separate income and loss figures and consolidated net operating losses:

	1977 *Taxable income or loss*	*1978* *Taxable income or loss*
Tobin Construction	($256,431)	($923,729)
O'Rourke	(195,891)	(200,660)
Divide	(107,220)	(78)
Rosedale	20,581	14,785
Consolidated net operating losses	(538,961)	(1,109,682)

The consolidated net operating losses, as reported on the consolidated Federal corporate income tax returns filed by Tobin Construction, O'Rourke, Divide, and Rosedale for 1977 and 1978, were carried back to the separate return of Tobin Construction for 1975 and to the consolidated return of Tobin Construction, O'Rourke, and Divide for 1976 as follows:

CARRYBACKS OF NOLs CLAIMED ON THE CONSOLIDATED 1977 AND 1978 FEDERAL INCOME TAX RETURNS

NOLs		CARRIED BACK TO:	
1977 Consolidated NOL carryback	*1978 Consolidated NOL carryback*	*1975 Separate return of Tobin Construction*	*1976 Consolidated return of Tobin Construction, O'Rourke and Divide*
$538,961		($254,260)	($284,701)
	[2]$1,109,681	(917,773)	(191,908)

Rosedale claimed a net operating loss of $171,730 on its separate Federal corporate income tax return for 1975. That net operating loss for 1975 was carried forward by Rosedale to its separate return for 1976 and to the separate taxable income of Rosedale for 1977 as reflected on the 1977 consolidated Federal income tax return of Tobin Construction, O'Rourke, Divide, and Rosedale as follows:

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[2] The record herein does not explain the $1 discrepancy between the 1978 consolidated net operating loss ($1,109,682) and the amount carried back ($1,109,681).

NOL	CARRIED FORWARD TO:	
1975 Separate NOL of Rosedale	*1976 Separate return of Rosedale*	*Separate income of Rosedale on 1977 consolidated return of Tobin Construction, O'Rourke, Divide, and Rosedale*
($171,730)	$79,929	$91,801

During the years 1975, 1976, 1977, and 1978, Tobin Construction transferred funds to O'Rourke on a monthly basis which funds O'Rourke used to pay operating expenses and to make payments on the $2.9-million bank loan that O'Rourke had obtained to purchase Joseph's stock in Tobin Construction. The transfers to O'Rourke were reflected on Tobin Construction's books and financial statements as loans to O'Rourke.

O'Rourke made no repayment of any of the funds transferred to it by Tobin Construction except that two tax refunds (that apparently were attributable to O'Rourke's losses as reflected on the consolidated returns) were treated on the intercompany books as payments to Tobin Construction in partial repayment by O'Rourke of some of the funds O'Rourke had received from Tobin Construction. Typically, the balance of the receivable account on Tobin Construction's books with respect to funds it had transferred to O'Rourke was reduced by the declaration of cash dividends by Tobin Construction in favor of O'Rourke. No actual payment of dividends occurred. In order to fulfill its obligation to pay dividends declared, Tobin Construction simply would debit its dividends payable account reflecting dividends owed to O'Rourke and credit its receivable account reflecting amounts that previously had been transferred to O'Rourke and that had been accounted for by Tobin Construction as loans to O'Rourke.

Reflected below are the amount of funds transferred each year in this manner by Tobin Construction to O'Rourke, the tax refunds attributable to O'Rourke that were treated as having been transferred by O'Rourke to Tobin Construction, the cash dividends declared each year by Tobin Construction (which were used to reduce the receivable account of O'Rourke in favor of Tobin Construction), and the balance at the end of each year of the funds transferred by Tobin Construction to O'Rourke:

	Funds transferred	*Tax refunds debited to Tobin Construction*	*Dividends declared*	*Yearend balance of funds transferred*
1975	- - - - - - - - - - - - not in the record - - - - - - - - - - - -			
1976	$872,274	$122,000	0	$750,274
1977	612,093	0	$750,000	612,367
1978	579,933	72,500	600,000	519,800

The funds transferred by Tobin Construction to O'Rourke were not evidenced by written promissory notes. No interest was due on the funds. No repayment or maturity dates were fixed. In a footnote to petitioner's financial statements during the years in issue, the following statement was made with respect to the funds transferred:

> Tobin Construction is a wholly-owned subsidiary of O'Rourke which has required cash advances from Tobin Construction in order to fund certain operations and service its debt. Such advances are shown in the balance sheet as a receivable due from the parent. Further advances may be required in the future for these purposes. It is Tobin Construction's intention to declare cash dividends during [the years in question] to the parent, if the parent is unable to meet its obligations.

OPINION

Carryback of O'Rourke's Portion of the 1977 and 1978 Consolidated NOLs to Tobin Construction's 1975 Separate Return

Petitioner seeks to carry back the portion of the consolidated net operating losses for 1977 and 1978 attributable to O'Rourke to offset Tobin Construction's 1975 taxable income. Petitioner asserts that even though a consolidated return was not filed for 1975 by Tobin Construction and O'Rourke, it was intended for those two companies to file a consolidated return, and they failed to do so only because of a mistake of law or fact, or inadvertence. Under any of those circumstances, petitioner contends that a consolidated return will be deemed to have been filed for 1975 by Tobin Construction and O'Rourke. Petitioner cites section 1.1502–75(b)(3), Income Tax Regs., as authority. In the alternative, petitioner contends that O'Rourke was a member of the consolidated group "immediately after its organization" and that therefore, under section 1.1502–79(a)(2), Income Tax Regs., O'Rourke's net operating losses from 1977 and 1978 can be carried back to separate return years of other members of the consolidated group.

Respondent disagrees with petitioner's arguments primarily on factual grounds. Respondent contends that petitioner's failure to join in the filing of a consolidated return with O'Rourke for 1975 was intentional and was not due to a mistake of law or fact, or inadvertence. With regard to petitioner's alternative argument, respondent contends that O'Rourke was not a member of the consolidated group immediately after its organization and that since O'Rourke filed a separate return for 1975, its net operating losses for 1977 and 1978 cannot be carried back to Tobin Construction's 1975 separate return year. For the reasons explained below, we agree with respondent on both arguments.

With regard to petitioner's first argument, section 1.1502–75(b)(3), Income Tax Regs., does provide that where the failure to join in the filing of a consolidated return is due to a mistake of law or fact, or inadvertence, a consolidated return will be deemed to have been filed.[3] Petitioner asserts that its accountants were under the misapprehension that the acquisition by Patricia of O'Rourke and the acquisition by O'Rourke of Tobin Construction did not qualify as a reverse acquisition. Had the accountants realized that the reorganization did qualify as a reverse acquisition, petitioner argues that a consolidated return would have been filed under the authority of section 1.1502–75(d), Income Tax Regs. This argument fails because even if the acquisition of O'Rourke did not qualify as a reverse acquisition, a consolidated return still could have been filed by Tobin Construction and O'Rourke for part of 1975 under the consolidated return rules. See secs. 1501 and 1502 and the regulations thereunder. Thus, any mistake as to whether the acquisition qualified as a reverse acquisition was not a reason for not filing a consolidated return for at least part of 1975.

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[3] Sec. 1.1502–75(b)(3), Income Tax Regs., provides as follows:

(3) *Failure to consent due to mistake.* If any member has failed to join in the making of a consolidated return under either subparagraph (1) or (2) of this paragraph, then the tax liability of each member of the group shall be determined on the basis of separate returns unless the common parent corporation establishes to the satisfaction of the Commissioner that the failure of such member to join in the making of the consolidated return was due to a mistake of law or fact, or to inadvertence. In such case, such member shall be treated as if it had filed a Form 1122 for such year for purposes of paragraph (h)(2) of this section, and thus joined in the making of the consolidated return for such year.

Petitioner argues that a mistake of fact occurred that was responsible for a consolidated return not being filed. The only mistake of fact that occurred was the failure of petitioner's representatives to predict more accurately the future income and loss picture of the consolidated group. Errors in tax planning with respect to subsequent years' earnings and profits and tax liabilities arising therefrom surely do not rise to the level of a mistake of fact as contemplated by section 1.1502-75(b)(3), Income Tax Regs. See *Grynberg v. Commissioner*, 83 T.C. 255, 262-263 (1984); *Estate of Stamos v. Commissioner*, 55 T.C. 468, 474 (1970).

Petitioner also argues that the failure to file a consolidated return for 1975 was due to inadvertence. The testimony in this case is quite clear that petitioner's representatives considered filing a consolidated return for 1975 but affirmatively chose not to do so. The separate return for O'Rourke for 1975 was filed consciously and intentionally, and without inadvertence.

Although not entirely clear from petitioner's briefs, petitioner also apparently argues that a mistake of law occurred due to the failure of petitioner's representatives to realize that under section 1.1502-75(d), Income Tax Regs., Tobin Construction and O'Rourke could have filed a consolidated return for the entire 12 months of 1975 which, petitioner contends, would have been done if the representatives had realized that the acquisition of O'Rourke and its acquisition of the stock of Tobin Construction qualified as a reverse acquisition. To the extent petitioner does make that argument, it also must be rejected. Even if a mistake of fact or law, or inadvertence occurred, by its express terms the relief provision of section 1.1502-75(b)(3), Income Tax Regs., applies only to the situation where a consolidated return is filed by some members of the consolidated group (for the year for which relief is sought—namely, 1975 herein) and where the mistake causes one or more of the other members of the group to fail to join in the consolidated return that was filed. See *Lion Associates, Inc. v. United States*, 515 F. Supp. 550 (E.D. Pa. 1981). Here, no consolidated return was filed by any member of the consolidated group for any portion of 1975, and section 1.1502–75(b)(3), Income Tax Regs., is not applicable.

Petitioner makes the alternative argument that if O'Rourke is not deemed to have filed a consolidated return with Tobin Construction for 1975 under section 1.1502–75(b)(3), Income Tax Regs., the portion of the 1977 and 1978 consolidated net operating losses attributable to O'Rourke can be carried back to Tobin Construction's separate return for 1975 under the authority of section 1.1502–79(a)(2), Income Tax Regs. That regulation provides, among other things, that the portion of a consolidated net operating loss attributable to a particular corporation will be allowed as a carryback to a separate return of another member of the affiliated group if the corporation to whom the net operating loss in question is attributable was not yet organized in the separate return year in question and if that corporation became a member of the group immediately after its organization.[4] As part of its argument, petitioner asserts that during the period from July 15, 1974, to December 9, 1975, O'Rourke was an inactive "shelf" corporation and that O'Rourke should not be considered to have been in existence during that period. Also, petitioner cites section 1.1502–76(b)(5), Income Tax Regs., and argues that any period of time less than 30 days (namely, the 23 days from December 9, 1975, through December 31, 1975) may be ignored for purposes of the consolidated return regulations.[5] Based on the

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[4] Sec. 1.1502–79(a)(2), Income Tax Regs., provides—

(2) *Nonapportionment to certain members not in existence.* Notwithstanding subparagraph (1) of this paragraph, the portion of a consolidated net operating loss attributable to a member shall not be apportioned to a prior separate return year for which such member was not in existence and shall be included in the consolidated net operating loss carrybacks to the equivalent consolidated return year of the group (or, if such equivalent year is a separate return year, then to such separate return year), provided that such member was a member of the group immediately after its organization.

[5] Sec. 1.1502–76(b)(5), Income Tax Regs., provides—

(5) *Period of 30 days or less may be disregarded.* For purposes of the regulations under section 1502—

(i) If within a period of 30 days after the beginning of a corporation's taxable year (determined without regard to the required change to the parent's taxable year) it becomes a member of a group which files a consolidated return for a taxable year which includes such period, then such corporation may at its option be considered to have become a member of the group as of the beginning of the first day of such corporation's taxable year, or

(ii) If, during a consolidated return year of a group, a corporation (other than a corporation above arguments, petitioner asserts that O'Rourke should not be considered to have been organized and in existence until January 1, 1976, by which date it had become a part of the affiliated group. If correct, that argument would allow O'Rourke to carry back its portion of the 1977 and 1978 consolidated net operating losses to the 1975 separate return year of Tobin Construction.

Again, we must reject petitioner's argument. An inactive corporation is considered to be in existence for purposes of section 1.1502–79(a)(2), Income Tax Regs., from the date of its incorporation. *Braswell Motor Freight Lines, Inc. v. United States*, an unreported case (N.D. Tex. 1972, 30 AFTR 2d 72–5608, 72–2 USTC par. 9675), affd. 477 F.2d 594 (5th Cir. 1973), cert. denied 414 U.S. 1143 (1974).[6] Thus, O'Rourke (under its prior name of Three Central United) is considered to have been in existence from July 15, 1974. Because it was not a member of the affiliated group immediately after its organization, the portion of the 1977 and 1978 consolidated net operating losses attributable to O'Rourke cannot be carried back to the separate return of Tobin Construction for 1975.

With regard to petitioner's argument that the 23 days in December of 1975, during which O'Rourke was active, can be disregarded, we note that section 1.1502–76(b)(5), Income Tax Regs., expressly applies only to days that occur during a year for which a consolidated return is filed. Since Tobin Construction and O'Rourke filed separate returns for 1975, petitioner's reliance on that regulation is misplaced.

The facts of *Electronic Sensing Products, Inc. v. Commissioner*, 69 T.C. 276 (1977), are very similar to the facts of this case on this issue. A subsidiary was organized on October 6, 1972. The parent corporation and the subsidiary filed separate returns for their taxable periods ended October 31, 1972. Because the subsidiary was in existence in 1972 and because it filed a separate return for its short taxable year ended October 31, 1972, the portion of the consolidated net operating losses in

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created or organized in such year by a member of the group) has been a member of such group for a period of 30 days or less, then such corporation may at its option be considered as not having been a member of the group during such year.

[6] For purposes of sec. 1.1502–79(a)(2), Income Tax Regs., respondent apparently will not count a period of corporate inactivity immediately following incorporation if a request under sec. 1.6012–2(a)(2), Income Tax Regs., is filed for permission not to file corporate income tax returns for the period of inactivity. See Crestol, Hennessy & Rua, The Consolidated Tax Return, par 5.02 at 5–52 (1983).

a subsequent year that was attributable to the subsidiary could not be carried back to the separate return of the parent corporation ended October 31, 1972. *Electronic Sensing Products, Inc. v. Commissioner, supra* at 282–283; see also sec. 1.1502–79(a)(4), example (*1*), Income Tax Regs.; *Jim Burch & Associates, Inc. v. Commissioner*, 76 T.C. 202 (1981). The fact that O'Rourke existed in 1975 and filed a separate return for 1975 is fatal to petitioner's argument that section 1.1502–79(a)(2), Income Tax Regs., authorizes the portion of the 1977 and 1978 consolidated net operating losses attributable to O'Rourke to be carried back to Tobin Construction's separate return for 1975.

The Carryback of Divide's Portion of the 1977 and 1978 Consolidated NOLs to Tobin Construction's 1975 Separate Return

Since Divide was a member of the affiliated group immediately after its organization in 1976, petitioner argues that Divide's portion of the 1977 and 1978 consolidated net operating losses can be carried back to Tobin Construction's 1975 separate return.

As we have previously discussed, section 1.1502–79(a)(2), Income Tax Regs., provides, among other things, that if a loss member of an affiliated group was a member of the group immediately after its organization, the portion of a consolidated net operating loss attributable to that member can be carried back to a separate return of other members of the group. The regulation, however, is silent as to which member of the affiliated group is entitled to the carryback in the separate return year.

Petitioner asserts that Divide's portion of the 1977 and 1978 consolidated net operating losses should be carried back to Tobin Construction's 1975 separate return. Tobin Construction is, of course, a sister corporation of Divide. Respondent counters that Divide's portion of that consolidated net operating loss only can be carried back against O'Rourke's 1975 separate return. O'Rourke, of course, is the parent of Divide.

There is limited authority discussing this issue. In Rev. Rul. 74–610, 1974–2 C.B. 288, respondent states that the portion of a consolidated net operating loss attributable to a second tier subsidiary should be carried back to the separate return of the immediate parent corporation, not to the separate return of the common parent. The rationale for that holding was that the assets of the second tier subsidiary (i.e., the loss member) previously had been owned by the immediate parent corporation and but for the formation of the second tier subsidiary, the immediate parent (i.e., the first tier subsidiary) would have sustained the losses in the consolidated return year and the losses would have been carried back to the separate return of the immediate parent.

References to this issue in 8A J. Mertens, Law of Federal Income Taxation, sec. 46.104, at 131 (1985 rev.), and in J. Crestol, K. Hennessey & A. Rua, Consolidated Tax Return, par. 5.02 (iv), at 5–51 (3d ed. 1980), state that the immediate parent corporation will be allowed the carryback loss and no reference is made to a "but-for" test. In F. Peel, Consolidated Tax Returns, sec. 9:06, at 9–30 (3d ed. 1984), it is stated that ordinarily the carryback will be to the separate return year of the immediate parent corporation and the further explanation is given that—

> The principle that has developed is that the carryback is to the member that would have sustained the loss if the loss subsidiary had not been incorporated.

Petitioner argues that Tobin Construction, not O'Rourke, funded the operations and the acquisition of Divide and that, but for the existence of Divide, Tobin Construction would have incurred the net operating losses Divide incurred in 1977 and 1978. Petitioner therefore argues that those losses should be carried back to the 1975 separate return of Tobin Construction.

It is our opinion that in most situations involving this issue, a subsidiary corporation's portion of a consolidated net operating loss should be carried back to the separate return of the subsidiary's immediate parent corporation. We will not attempt to describe potential exceptions to that rule for we are not faced with an exception here. Although O'Rourke did receive some funds from Tobin Construction that were lent by O'Rourke to Divide, that fact does not establish an adequate basis to allocate the loss carryback in question to the 1975 separate return of Tobin Construction. O'Rourke was a viable corporate entity that was formed for valid business purposes.

It formed a new corporation (namely, Divide). It acquired two corporations (namely, Tobin Construction and Rosedale), and it filed a separate tax return for 1975. On the facts presented to us, there is no basis to allow a carryback of Divide's portion of the 1977 and 1978 consolidated net operating losses to the 1975 separate return of Tobin Construction.

The Carryforward of Rosedale's 1975 Separate Return Loss To Reduce Its Separate Taxable Income in 1977

Petitioner seeks to carry forward a loss of $91,801 from Rosedale's 1975 separate return to Rosedale's 1977 separate taxable income computation, thereby increasing the 1977 consolidated net operating loss that is available as a carryback to the 1975 separate return of Tobin Construction. Section 1.1502-21(c)(2), Income Tax Regs., allows a carryforward of a loss from a separate return limitation year (i.e., Rosedale's 1975 separate return year) to a consolidated return year where, among other things, there exists consolidated net taxable income in the carryforward year before the loss carryforward in question is applied. That regulation provides as follows:

> (c) Limitation on net operating loss carryovers and carrybacks from separate return limitation years—
>
> * * * * * * *
>
> (2) *Computation of limitation.* The amount referred to in subparagraph (1) of this paragraph with respect to a member of the group is the excess, if any, of—
>
> (i) Consolidated taxable income (computed without regard to the consolidated net operating loss deduction), minus such consolidated taxable income recomputed by excluding the items of income and deduction of such member, over
>
> (ii) The net operating losses attributable to such member which may be carried to the consolidated return year arising in taxable years ending prior to the particular separate return limitation year.

Section 1.1502-21(c), Income Tax Regs., was promulgated under the specific authority of section 1502. Furthermore, the regulation has been upheld by each court that has considered its validity or its application. See *Wolter Construction Co. v. Commissioner*, 68 T.C. 39, 48 (1977), affd. 634 F.2d 1029 (6th

Cir. 1980). Addressing the predecessor regulation in *Foster v. Commissioner*, T.C. Memo. 1966–273, remanded on another issue sub nom. *Likins-Foster Honolulu Corp. v. Commissioner*, 417 F.2d 285 (10th Cir. 1969), cert. denied 397 U.S. 987 (1970), we rejected the same argument made herein and stated that—

> Unless there is consolidated net income prior to the use of any net operating loss carryover, there is no income of the consolidated group against which to apply a carryover and therefore no reason for application of a carryover. * * * [25 TCM 1390, at 1413, 35 P-H Memo T.C. par. 66,273, at 66–1581.]

See also *Phinney v. Houston Oil Field Material Co.*, 252 F.2d 357 (5th Cir. 1958); *Likins-Foster Honolulu Corp. v. Commissioner, supra.*

For the reasons set forth above, Rosedale cannot carry forward its 1975 net operating loss of $91,801 to reduce its 1977 separate taxable income computation.

Imputed Interest Income Adjustment Under Section 482

In his statutory notice of deficiency for 1977 and 1978, respondent determined that the funds transferred by Tobin Construction to O'Rourke constituted loans, not corporate distributions. Since Tobin Construction had not charged O'Rourke interest on the loans, under the authority of section 482, respondent imputed interest income in the amount of $69,303 for 1977 and $53,697 for 1978 to Tobin Construction with respect to the funds that respondent determined had been loaned to O'Rourke. Imputed interest expenses in the same amounts were allowed to O'Rourke for 1977 and 1978, as correlative adjustments required under section 1.482–1(d)(2), Income Tax Regs.

The imputed interest income was computed on the average balances throughout 1977 and 1978 of the funds transferred from Tobin Construction to O'Rourke. The interest rate used was 7 percent. Respondent's imputed interest income adjustments resulted in additional income of $990,044 and $767,101 being charged to Tobin Construction for 1977 and 1978.

Respondent relies primarily on section 1.482–2(a)(1), Income Tax Regs., which provides as follows:

> Sec. 1.482–2. Determination of taxable income in specific situations.—

> (a) *Loans or advances*—(1) *In general.* Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

Petitioner argues that the above regulation applies only to valid indebtedness and not to payments between related entities that, for accounting purposes only, were reflected on the books of the related entities as loans, but that, in substance, were corporate distributions. Petitioner cites section 1.482-2(a)(3), Income Tax Regs., which provides as follows:

> (3) *Loans or advances to which subparagraph (1) applies.* Subparagraph (1) of this paragraph applies to all forms of *bona fide* indebtedness and includes:
>
> (i) Loans or advances of money or other consideration (whether or not evidenced by a written instrument), and
>
> (ii) Indebtedness arising in the ordinary course of business out of sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.
>
> *Subparagraph (1) of this paragraph does not apply to alleged indebtedness which was in fact a contribution of capital or a distribution by a corporation with respect to its shares.* * * *
>
> [Emphasis added.]

Petitioner and respondent each cite numerous cases in support of their respective characterizations of the funds transferred as loans or corporate distributions.

In the typical case involving the characterization of funds transferred between related entities as loans or distributions, the positions of the parties are reversed from what they are herein. Taxpayers typically seek to treat the funds as loans and respondent seeks to treat the funds as dividend distributions.[7] Herein, however, petitioner is seeking distribution treatment for the funds transferred, and respondent is seeking loan treatment therefor in order to support his adjustment for imputed interest income under section 482.

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[7] See, for example, *Williams v. Commissioner*, 627 F.2d 1032 (10th Cir. 1980), affg. a Memorandum Opinion of this Court; *Dolese v. United States*, 605 F.2d 1146 (10th Cir. 1979), cert. denied 445 U.S. 961 (1980); *Road Materials, Inc. v. Commissioner*, 407 F.2d 1121 (4th Cir. 1969), affg. a Memorandum Opinion of this Court; *Ludwig Baumann & Co. v. Commissioner*, 312 F.2d 557 (2d Cir. 1963), affg. a Memorandum Opinion of this Court.

Section 482 adjustments made by respondent carry with them a heavy presumption of correctness and petitioner has the burden of proof as to the character of the funds transferred to O'Rourke. *Commissioner v. Transport Mfg. & Equip. Co.*, 478 F.2d 731, 734–736 (8th Cir. 1973), affg. *Riss v. Commissioner*, 56 T.C. 388 (1971), and 57 T.C. 469 (1971) (supplemental opinion); *Foster v. Commissioner*, 80 T.C. 34, 142–144 (1983), affd. on this issue 756 F.2d 1430 (9th Cir. 1985).

We also note that a taxpayer generally is not allowed to argue that the substance of a transaction was other than the form he chose. The substance-over-form argument is always available to respondent, but it is available to taxpayers only on a limited basis. The rationale has been stated as follows:

> As a general rule, the government may indeed bind a taxpayer to the form in which he has factually cast a transaction. The rule exists because to permit a taxpayer at will to challenge his own forms in favor of what he subsequently asserts to be true "substance" would encourage post-transactional tax-planning and unwarranted litigation on the part of many taxpayers and raise a monumental administrative burden and substantial problems of proof on the part of the government. [Citations omitted.]

In re Steen v. United States, 509 F.2d 1398, 1402–1403 n. 4 (9th Cir. 1975). That rule, however, is not absolute,[8] and section 1.482–2(a)(3), Income Tax Regs., previously cited herein, states that interest income adjustments under section 482 are not to be made by respondent where the underlying transaction was not a bona fide loan. The regulation places no express restriction on a taxpayer's (as distinguished from respondent's) ability to challenge the bona fide nature of the loan and nothing in the regulation suggests that only respondent can make that argument. Furthermore, in this case, respondent does not argue that petitioner, as a matter of law, is held to the form of the transaction.

We also note that although certain aspects (namely, the accounting entries) of the transfers in question took the form of loans, other aspects of the transfers do not support a finding that the form of the transfers was that of a loan. In other words, both the form and substance of the transfers in question are in dispute.

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[8] See, e.g., *Hoffman Motors Corp. v. United States*, 473 F.2d 254, 257 (2d Cir. 1973); *Swan v. Commissioner*, 355 F.2d 795, 797–798 (6th Cir. 1966), affg. 42 T.C. 291 (1964); *Frelbro Corp. v. Commissioner*, 315 F.2d 784, 786 (2d Cir. 1963), revg. 36 T.C. 864 (1961); *Ciaio v. Commissioner*, 47 T.C. 447, 457 (1967).

On the facts of this case, it is appropriate to consider all of the facts and circumstances pertinent to the transfers in order to decide whether these transfers, in substance, were loans or corporate distributions to petitioner's sole shareholder. That is a factual issue and depends primarily upon the good-faith intention of the shareholder to repay the amounts received and the intention of the corporation to require repayment. *Williams v. Commissioner*, 627 F.2d 1032, 1034 (10th Cir. 1980), affg. a Memorandum Opinion of this Court; *Pierce v. Commissioner*, 61 T.C. 424, 430 (1974). In the case of a closely held corporation, special scrutiny is required because of the unfettered control exercised by a limited number of shareholders. *Roschuni v. Commissioner*, 29 T.C. 1193, 1201–1202 (1958), affd. per curiam 271 F.2d 267 (5th Cir. 1959).

Mere declarations by a shareholder that he intended a transaction to constitute a loan is insufficient if the transaction fails to meet more reliable indicia of debt which indicate the "intrinsic economic nature of the transaction." *Williams v. Commissioner, supra* at 1034; *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 697 (3d Cir. 1968). In making the necessary factual determination, courts have looked to a number of objective factors including the following:

> (1) the extent to which the shareholder controlled the corporation;
> (2) the earnings and dividend history of the corporation;
> (3) the magnitude of the payments;
> (4) whether a ceiling existed to limit the amount of the corporate payments;
> (5) whether or not security was given for the payments;
> (6) whether there was a set maturity date;
> (7) whether the corporation ever undertook to force repayment;
> (8) whether the shareholder was financially able to repay the payments; and
> (9) whether there was any indication the shareholder attempted to repay the amounts received.

Dolese v. United States, 605 F.2d 1146, 1153 (10th Cir. 1979), cert. denied 445 U.S. 961 (1980); *Alterman Foods, Inc. v. United States*, 505 F.2d 873, 877 n. 7 (5th Cir. 1974). Also relevant are the treatment of the funds on the books of the corporation, the substantiality of any repayments made by the shareholder, and the existence of corporate earnings and profits at the time the funds were transferred. *Pierce v. Commissioner*, 61 T.C. at 430–431.

As stated, the funds in question lacked much of the form of loans and very little of the substance. No promissory notes were issued. No interest payments were due. No maturity dates were set. No security was established. What repayments occurred were in effect little more than bookkeeping entries with respect to the respective contributions of the related entities to the consolidated tax liabilities of the group. No cash repayments occurred.

The record does not indicate that any formal dividends were declared by Tobin Construction other than the dividend declarations that were necessary to enable petitioner to reverse accounting entries that had been made reflecting the balance of the intercompany receivable account. No cash dividends were paid to O'Rourke in connection with the dividends declared. The funds that had been transferred prior to the declaration of the dividends (namely, the funds in question herein) simply were treated as satisfying the obligation of Tobin Construction to pay the dividends declared. Such accounting entries appear to have been intended from the outset. In other words, the ultimate form and substance of the transfers in question from Tobin Construction to O'Rourke were dividends.

O'Rourke had no intention of repaying the funds transferred, and Tobin Construction had no intention of being repaid by O'Rourke. The footnote references in Tobin Construction's financial statements, although they mention repayment as a possibility, are more significant in their acknowledgement that the funds transferred likely were to be recharacterized as dividends even for accounting purposes, which is what occurred.

For the reasons set forth above, we conclude that the funds in question were not loans, but were corporate distributions from Tobin Construction to O'Rourke, its sole shareholder. Accordingly, we find for petitioner on this issue.

Decision will be entered under Rule 155.

MARTIN I. GREENE AND JUNE A. GREENE, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 25789-83. Filed December 24, 1985.

P surrendered an annuity policy with company A, and used the proceeds to purchase an equivalent policy with company B. There were no restrictions placed on the use of the funds which P received from company A. *Held*, the transaction was a nontaxable exchange within the meaning of sec. 1035, I.R.C. 1954.

Leonard J. Witman, for the petitioners.
Robert A. Stern, for the respondent.

KÖRNER, *Judge*: Respondent determined a deficiency in the petitioners' income tax for the calendar year 1980 in the amount of $16,007.50, together with an addition to tax under section 6653(a)[1] in the amount of $800.37. After concessions, the only issue for us to decide in this case is whether petitioner June A. Greene's surrender of an annuity contract which she had with one insurance company, and the immediate reinvestment of the proceeds thereof in a comparable annuity contract with another company, gave rise to taxable income in 1980, the year of the transaction.

The facts herein were largely stipulated, and such stipulation of facts, together with joint exhibits, are incorporated herein by this reference.

FINDINGS OF FACT

Petitioners, husband and wife, were residents of Livingston, New Jersey, at the time their petition herein was filed. They timely filed a joint Federal income tax return for the year 1980 with respondent's service center at Holtsville, New York.

During the period September 1966 through March 1985, petitioner June Greene (hereinafter petitioner)[2] was a schoolteacher employed by the Livingston, N.J., Board of Education, and was so employed at the time of trial herein. In the period September 1975 through October of 1980, the Livingston Board of Education made payments, pursuant to a salary reduction agreement, to an annuity plan qualifying under section 403(b), for petitioner's benefit. The annuity contract was issued by the Variable Annuity Life Insurance Co. (VALIC). Petitioner's policy with VALIC was a fixed interest annuity account. Pursuant to the salary reduction agreement between petitioner and the Board of Education, as amended from time to time, the Board of Education paid designated amounts to VALIC in certain of petitioner's pay periods for the purpose of funding petitioner's annuity contract.

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[1] All statutory references are to the Internal Revenue Code of 1954 as in effect in the year in issue, and all Rule references are to the Tax Court Rules of Practice and Procedure, except as otherwise noted.

[2] Petitioner Martin I. Greene is involved herein only by having filed a joint return with petitioner June A. Greene, and will not be referred to hereinafter.

On October 24, 1980, petitioner signed a form with VALIC, under which she surrendered her annuity contract with that company and demanded the payment of the proceeds of the account to her. It was her intention to take these proceeds and use them to fund a new annuity account, qualifying under section 403(b), which she would purchase from the Charter Security Life Insurance Co. (Charter).

VALIC would not surrender the funds in petitioner's annuity account with it directly to Charter, but would surrender the funds directly to petitioner. On October 28, 1980, VALIC issued its check in the amount of $35,337.14 to petitioner, representing the credit balance in petitioner's VALIC annuity contract. Petitioner received this check shortly thereafter, and, on November 5, 1980, she filled out an appropriate application form from Charter for the purpose of opening a section 403(b) annuity account with Charter. To this application she attached the check which she had received from VALIC, which she had endorsed in favor of Charter.

Petitioner's application to Charter, together with her endorsed check from VALIC, was received by Charter on November 10, 1980, and Charter issued its new policy in her favor on the following day. Said policy, with a later minor modification with respect to the effective interest rate, was then continued in effect thereafter.

No binding agreement or any other contracts were signed between petitioner and Charter which would have required her to endorse or pay over the VALIC check to Charter, once received by her. Petitioner was free to use the check from VALIC in any way she wished and was in no way obligated to use such funds to purchase the new annuity contract with Charter.

OPINION

On the basis of the above set of simple and uncontradicted facts, petitioner contends that her surrender of her VALIC annuity, and the prompt use of the proceeds thereof to purchase a new and comparable annuity from Charter, constituted a nontaxable exchange within the meaning of section 1035. Respondent, on the other hand, contends that there was no exchange within the meaning of that Code section, but rather a surrender of the VALIC policy, with the proceeds thereof being paid to petitioner, who thereafter reinvested such proceeds in a new annuity contract with Charter. Since petitioner was under no binding obligation to use the proceeds of the VALIC policy in this fashion, respondent argues, the transaction did not fall within the ambit of section 1035, and was therefore taxable.[3]

Section 72(e) provides, in general, that (a) if an amount is received under an annuity contract, but (b) is not received as an annuity, and (c) if no other provision of the income tax laws applies, then such amount shall be taxable to the recipient, as therein provided.[4]

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[3] The parties are in agreement that the provisions of sec. 403(b)(8) (concerning "rollover
amounts") do not apply in the instant case. Although the Court is not bound by the stipulation of
the parties as to matters of law, see *King v. United States*, 641 F.2d 253 (5th Cir. 1981), we have
examined independently the provisions of sec. 403(b)(8), and we conclude that such section does not
apply herein, since the distribution of the balance of the VALIC account to petitioner did not
constitute a "qualifying distribution" within the meaning of sec. 403(b)(8) and sec. 402(e)(4)(A), as
in effect in 1980.

[4] Sec. 72(e) provided as follows:

SEC. 72(e). Amounts Not Received as Annuities.—

(1) General rule.—If any amount is received under an annuity, endowment, or life insurance
contract, if such amount is not received as an annuity, and if no other provision of this subtitle
applies, then such amount—

(A) if received on or after the annuity starting date, shall be included in gross income; or

(B) if subparagraph (A) does not apply, shall be included in gross income, but only to the
extent that it (when added to amounts previously received under the contract which were
excludable from gross income under this subtitle or prior income tax laws) exceeds the
aggregate premiums or other consideration paid.

For purposes of this section, any amount received which is in the nature of a dividend or similar
distribution shall be treated as an amount not received as an annuity.

(2) Special rules for application of paragraph (1).—For purposes of paragraph (1), the
following shall be treated as amounts not received as an annuity:

(A) any amount received, whether in a single sum or otherwise, under a contract in full
discharge of the obligation under the contract which is in the nature of a refund of the

It is clear from the facts in this case, and the parties do not dispute, that the proceeds received by petitioner from VALIC were "received under an annuity contract" within the meaning of section 72(e), and were likewise not "received as an annuity," within the meaning of such section. There is likewise no disagreement between the parties that both the VALIC contract which petitioner surrendered, as well as the Charter contract which petitioner purchased, were annuity contracts within the meaning of section 403(b). Unless some other Code provision applies, therefore, the VALIC proceeds would appear to be taxable to petitioner. Section 1035, however, as pertinent herein, provides as follows:

> SEC. 1035. CERTAIN EXCHANGES OF INSURANCE POLICIES.
>
> (a) GENERAL RULES.—No gain or loss shall be recognized on the exchange of—
>
> * * * * * * *
>
> (3) an annuity contract for an annuity contract.
>
> (b) DEFINITIONS.—For the purpose of this section—
>
> * * * * * * *
>
> (2) ANNUITY CONTRACT.—An annuity contract is a contract to which paragraph (1) applies but which may be payable during the life of the annuitant only in installments.

Respondent's regulations, in turn, provide in pertinent part:

> Sec. 1.1035–1. Certain exchanges of insurance policies.
>
> Under the provisions of section 1035 no gain or loss is recognized on the exchange of—
>
> * * * * * * *
>
> (c) An annuity contract for another annuity contract (section 1035(a)(3)), but section 1035 does not apply to such exchanges if the policies exchanged do not relate to the same insured. The exchange, without recognition of gain or loss, of an annuity contract for another annuity contract under section 1035(a)(3) is limited to cases where the same person or persons are the obligee or obligees under the contract received in exchange as under the original contract. * * *
>
> [Sec. 1.1035–1, Income Tax Regs.]

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consideration paid for the contract; and

(B) any amount received under a contract on its surrender, redemption, or maturity. In the case of any amount to which the preceding sentence applies, the rule of paragraph (1)(B) shall apply (and the rule of paragraph (1)(A) shall not apply).

Assuming, then, that what took place here was an "exchange" within the meaning of section 1035, it would appear that petitioner fits cleanly within the provisions of that section, and should be entitled to the nonrecognition treatment there afforded.

It must be admitted that in the conventional and ordinarily accepted meaning of the word, what took place here did not strictly constitute an exchange. In normal parlance, "exchange" would connote the transfer of property by A to B, in return for which B would transfer property to A.[5] We are satisfied, however, that Congress intended the use of the word in the broader sense, as where the taxpayer gives up an insurance contract with one company, in order to procure the same or a comparable contract from another company. Viewed from the standpoint of the insured taxpayer, he has simply "exchanged" one policy for another just like it, albeit with two different companies. Our interpretation is fortified by the applicable regulation interpreting section 1035, which requires only that the insurance contracts be of the same type, e.g., an annuity for an annuity, and that the obligee under the two contracts be the same person, viz, the taxpayer. See sec. 1.1035-1, Income Tax Regs.

Respondent has previously recognized the validity of the above propositions. In a fact situation not materially different from that presented in the instant case, respondent, in Rev. Rul. 73-124, 1973-1 C.B. 200, ruled:

> In a single integrated transaction, the employee then surrendered his entire interest in the first contract to the insurer in exchange for a check which he immediately endorsed and paid over to the employer for use in providing benefits under the second contract.
>
> * * * * * * *
>
> In this case, the same employee is the obligee under the contract received as under the contract surrendered. The fact that the employee must first surrender the original annuity contract to an insurer because of the restrictions required by section 401(g) of the Code does not prevent the total transaction from being an exchange within the meaning of section 1035 of the Code provided the proceeds received upon surrender are applied

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[5] "Exchange of goods is a commutation, transmutation, or transfer of goods for other goods, as distinguished from *sale*, which is a transfer of goods for money." Black's Law Dictionary (3d ed. 1933), defining "exchange" in the law of personal property.

immediately to the purchase of a second annuity contract for the same employee.

In this case, however, respondent seeks to impose an additional requirement upon petitioner, in order to block the application of section 1035. Respondent urges that, prior to the receipt of the funds from VALIC, petitioner was required to have entered into a "binding obligation" with Charter to turn the VALIC proceeds over to Charter for the issuance of a new annuity contract. Absent such a "binding obligation," respondent urges, petitioner was free to do what she wished with the VALIC proceeds, and thus no exchange within the meaning of section 1035 took place, even though petitioner in fact did turn over the VALIC proceeds to Charter immediately, by endorsing over the VALIC check to Charter and sending it in with her Charter application. Thus, as respondent states on brief:

> It is respondent's position that employer intervention is not essential to achieving nonrecognition of gain under the provisions of the statute. Therefore the fact that VALIC would pay the surrender proceeds only to the petitioner did not preclude the petitioner from invoking the provisions of IRC §1035(a)(3). However, once the petitioner received physical possession of the surrendered proceeds without a binding obligation to turn over the funds to Charter Life, petitioner was precluded from executing a valid IRC §1035(a)(3) annuity exchange. This is the salient factor for purposes of compliance with the Revenue Ruling.

We seek in vain to find any authority to support respondent's position here. Neither the statute nor the regulations contain any such requirement, either expressly or by any necessary implication. The parties have not cited to us, and our research has not uncovered any case dealing with the question. The case thus appears to be one of first impression.

Nor do we find respondent's position supported by logic. What kind of "binding obligation" would respondent require petitioner to enter into with Charter in a situation such as this?[6] Charter would clearly not issue a new annuity policy to petitioner unless it was paid, and petitioner clearly could not demand the issuance of a new policy until she paid for it. Any "agreement" entered into between petitioner and Charter thus would clearly be executory on both sides, with performance by one side contingent upon performance by the other side. If petitioner failed to use the proceeds of her VALIC policy, or equivalent funds, to pay for the issuance of a new annuity policy by Charter, then Charter would clearly not issue it. In the circumstances of this case, we fail to see how any meaningful "binding obligation" could have been entered into between petitioner and Charter which would have any controlling effect in the premises.

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[6] Note that respondent is not arguing that petitioner had to enter into any form of "binding obligation" with VALIC, the first company in which she had her annuity, and the company which paid her the money.

So far as respondent's reliance on Rev. Rul. 73–124 is concerned, we note that revenue rulings do not have the force of law and are merely statements of the Commissioner's litigating and administrative positions. *Dixon v. United States*, 381 U.S. 68, 73 (1965); *Stubbs, Overbeck & Associates v. United States*, 445 F.2d 1142, 1146–1147 (5th Cir. 1971). Even if we were to give precedential weight to respondent's revenue ruling here, we do not think it stands for the proposition cited. The ruling merely stands for the proposition that under the facts there given, not distinguishable from the facts in the instant case, a valid exchange of insurance policies within the meaning of section 1035 took place, without reference to any alleged "binding agreement."

Finding no warrant for respondent's position herein, and finding that petitioner acted within the clear terms of section 1035 and the applicable regulation, we hold that her exchange of her VALIC annuity policy for a new Charter annuity policy was within the terms of section 1035, and that no gain or loss should be recognized to petitioner by reason of the exchange.

Decision will be entered under Rule 155.

Anesthesia Service Medical Group, Inc., Employee Protective Trust, San Diego Trust & Savings Bank, Trustee, Petitioner v. Commissioner of Internal Revenue, Respondent

Anesthesia Service Medical Group, Inc., Petitioner v. Commissioner of Internal Revenue, Respondent

Docket Nos. 13935–83, 13936–83. Filed December 24, 1985.

ASMG, a medical professional corporation, established trust to provide protection for malpractice claims resulting from acts of ASMG's employees. *Held*, ASMG may not deduct contributions to trust. *Held, further*, trust was not a Voluntary Employees' Beneficiary Association. *Held, further*, trust is not taxable as an insurance company. *Held, further*, trust constituted a trust and not an association for tax purposes. *Held, further*, trust was a grantor trust whose income is taxable to ASMG.

Raymond F. Zvetina and *Edward L. Kane*, for the petitioners.

M.K. Mortensen, for the respondent.

COHEN, *Judge*: Respondent determined the following deficiencies in petitioners' Federal income taxes:

Petitioner	*Year*	*Deficiency*
Anesthesia Service Medical Group, Inc. (ASMG) Docket No. 13936–83	1974	$4,155
	1976	1,411
	1977	207,313
	1978	264,619
	1979	144,762
Anesthesia Service Medical Group, Inc. Employee Protective Trust (trust) Docket No. 13935–83	1977	332,602
	1978	358,606
	1979	289,720

By amended answer respondent determined increased deficiencies in tax of petitioner ASMG of $300 for 1978 and $27,601 for 1979. The issues for decision are as follows: (1) Whether petitioner ASMG may deduct contributions made to petitioner trust; (2) whether petitioner trust was a Voluntary Employees' Beneficiary Association; (3) whether petitioner trust is taxable as an insurance company; (4) whether petitioner trust constituted an association or a trust for tax purposes; and (5) whether petitioner trust was a grantor trust.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts and exhibits attached thereto are incorporated herein by this reference.

Petitioner Anesthesia Service Medical Group, Inc. (ASMG), is a California professional corporation incorporated on April 16, 1970, and having its principal place of business in San Diego, California. ASMG maintained its books and records and filed its Federal income tax returns on the cash method of accounting and the calendar year.

Petitioner Anesthesia Service Medical Group, Inc., Employee Protective Trust (the trust) is a trust established in California on December 31, 1976. The trust maintained its books and records and filed returns (reporting an exemption from income tax under section 501(c)(9)[1]) on the accrual method of accounting and the calendar year.

ASMG's principal activity was the rendition of anesthesiology services to patients through its physician employees, primarily at eight San Diego County hospitals. ASMG recruited prospective physician employees primarily from medical schools, teaching institutions, and the military. To maintain employment with ASMG, a physician had to be accepted as a diplomate of the American Board of Anesthesiology within 78 months from the time of initial employment with ASMG.

The number of physician employees of ASMG ranged from 49 in 1974 to 56 in 1979. The number of nonphysician employees of ASMG ranged from 26 in 1974 to 34 in 1979.

After 2 years of employment with ASMG, a physician became entitled to purchase 1 share of ASMG stock. The number of outstanding shares ranged from 43 in 1974 to 52 in 1979. Outstanding shares were owned only by physician employees actively practicing anesthesiology, and no shareholder owned more than 1 share.

Various factors necessitated that ASMG maintain protection covering malpractice acts of its employees. The hospitals served by ASMG and third-party health care providers, such as Aetna and Blue Cross, required that physicians carry malpractice insurance or similar financial protection. The San Diego County Greater Health Plan, a group of physicians organized in 1978 to provide health insurance to employers and their employees and of which ASMG was a member, required all members to provide malpractice protection. Under regulations promulgated by the California Board of Medical Quality Assurance, all shareholders of a professional corporation with more than three shareholders were jointly and severally liable for professional negligence claims against the corporation to the extent of $150,000 per claim or $450,000 for all claims per year, unless the corporation possessed malpractice insurance or other security in such amounts. ASMG would have been unable to employ highly qualified physicians unless it provided malpractice protection.

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

From the date of incorporation through 1976, ASMG purchased commercial malpractice insurance covering acts of its employees from various independent insurance companies. The annual policies purchased for 1974, 1975, and 1976 provided maximum coverage of $5 million per claim and $5 million for all claims per year. The cost to ASMG of such policies rose from $4,116 per physician employee in 1974 to $19,507 per physician in 1976. After receiving a 1977 premium quote of $23,076 per physician for a policy providing maximum coverage of $1 million per claim and $1 million for all claims, ASMG decided, based upon a non-unanimous shareholder vote, to discontinue purchasing commercial malpractice insurance and provide malpractice protection through the trust.

ASMG established the trust on December 31, 1976. The declaration of trust, executed by San Diego Trust & Savings Bank, as trustee (trustee), and ASMG, as trustor, directed trustee to pay, for the benefit of ASMG's employees (not limited to physicians)—

> amounts certified for payment in accordance with Trustor's employment contract by a claims committee appointed by the Board of Directors of Trustor, for liability for claims of medical malpractice which relate to a liability imposed on such beneficiary by law for damages arising out of the performance by such beneficiary of professional services rendered or which should have been rendered during the time such person was an Employee of Trustor * * *. Certification by the Claims Committee shall be conclusive as

to the eligibility of the claim for payment and the Trustee shall have no liability because of any payment made in accordance with such certification.

* * * * * * *

The limits of the payments from the Trust for one claim shall be One Million Dollars ($1,000,000.00) and said amount shall be the total limit of the payments for all damages exclusive of costs of defense and supplemental payments, arising out of the rendering or failing to render professional services upon which the claim is based, regardless of the number of persons who sustain damages, the number of claims reported or suits filed on account of such damages, or the number of Employees or beneficiaries involved or alleged to be involved therein. * * *

* * * * * * *

If the covered beneficiary has valid and collectible insurance coverage as to any claim or suit to which this Paragraph A applies, the payment to be made under this Paragraph shall not apply unless and until the limits of liability of such insurance have been exhausted, and then only in an amount necessary to make the total coverage including the insurance, equal to the sum of One Million Dollars ($1,000,000.00).

Under the declaration of trust, ASMG's board of directors could direct trustee to purchase a commercial malpractice policy instead of paying the above amounts.

The declaration of trust directed trustee to invest trust assets in "eligible securities" as defined in section 16430 of the California Government Code. Although the trust instrument gave trustee the power to "manage, control, sell, and exchange" trust assets, trustee was not to invest in eligible securities the income from which was subject to Federal income tax, without prior approval of an investment committee appointed by ASMG.

ASMG retained the power to amend the terms of the trust, including replacement of trustee and termination of the trust. Under no circumstances, however, could trust assets be distributed to or for the benefit of ASMG or its employees, except for the payment of malpractice claims or the purchase of malpractice insurance. Upon termination of the trust, trust assets would be distributed to tax-exempt corporations qualifying under section 501(c)(3) and selected by ASMG's board of directors.

The employment contract between ASMG and its employee physicians for 1977, referred to in the declaration of trust and executed on December 31, 1976, provided that each physician would work exclusively for ASMG and that all accounts receivable for professional services rendered by the physician would be the property of ASMG. Under the contract, ASMG agreed to pay each physician compensation equal to a percentage of the excess of the monthly collections on accounts receivable generated by the physician over $1,296. The percentage was 71.3 percent until the physician's compensation exceeded the maximum amount upon which contributions could be made under ASMG's retirement plans and 89.1 percent thereafter. No compensation was payable to the physician, however, when the balance of the accounts receivable attributable to him was less than $20,000.

The employment contract also stated:

> Employer [ASMG] has established and agrees to maintain for the benefit of its Employees, a trust to pay on behalf of the Employee, claims of medical malpractice * * *
>
> * * * subject to the one million dollar limitation * * * and only to the extent of funds available, Employer shall provide through a trust agreement for the payment on behalf of the Employee amounts for liability for claims of medical malpractice * * *

After describing the terms of payment contained in the declaration of trust, the contract further provided:

> Employer and [physician] Employee recognize that it is not possible to predict or guarantee the sufficiency of any fund or trust to cover the cost of claims of medical malpractice arising during any particular period, and that the Employer's ability to pay compensation to Employee will be affected by Employer's obligation to make contributions to the Trust. The parties hereto, the Employer and each Employee, therefore agree as follows:
>
> (1) The accounting of the Trust established by Employer shall be on a separate fiscal year basis, beginning with the Trust's Fiscal Year 1977. The funds accumulated for that year, less any ultimate tax cost to Employer of providing the funds in trust, plus the income on the funds as accumulated, less any tax on such income, shall be used to pay the costs (including administrative, defense, settlement, and payment of claims) of the claims covered by this Paragraph 15 which arose out of incidents occurring during that fiscal year. To the extent that such funds are more than sufficient to cover the final costs of claims because of events occurring during that year, the balance of the funds will be carried forward and credited to the next year, and the same process shall be repeated for each succeeding fiscal year. To the extent that the funds for any fiscal year are insufficient to cover the cost of claims because of events occurring during any year, the insufficiency shall be made up as set forth below.

> (2) In the event of an insufficiency of the funds for any fiscal year to cover the cost of malpractice claims arising out of events occurring during that year, as determined by Employer from time to time, the compensation of each Employee who was employed during that fiscal year shall be adjusted by an amount not to exceed the Employee's gross compensation from Employer for the fiscal year involved, determined as provided below, and Employee shall be obligated to repay to Employer the amount of the adjustment in compensation.
>
> (3) The amount of the adjustment to compensation for the Employee for the fiscal year shall be determined by the Board of Directors by dividing the total amount required for that fiscal year by the total number of anesthesiologist Employees who were employed at any time during that year. * * *
>
> (4) The amount of the adjustment shall be due thirty (30) days from the date of mailing of written notice from the Board to the Employee. The amount of any such adjustment shall be a personal obligation of Employee * * *

An amendment to the employment contract, executed on February 3, 1977, limited the payments from the trust for all claims against any one physician to $2 million for the year. ASMG's board of directors dictated the amount of contributions that ASMG made to the trust. At the direction of the board, ASMG made monthly contributions totaling $10,000 per physician employee in both 1977 and 1978. In early 1977, ASMG borrowed $450,000 from a bank to purchase a certificate of deposit in that amount. ASMG used such certificate as security to avoid the joint and several liability of its shareholders under the regulation of the California Board of Medical Quality Assurance. By the end of 1977, the trust possessed sufficient assets for such security. ASMG thereupon redeemed the certificate of deposit and repaid the loan. In late 1978, the board decided to continue the $10,000 annual contribution per physician but to limit the cumulative contribution to $25,000 per physician. Aggregate annual contributions from ASMG to the trust and yearend values of trust assets were as follows:

Year	*Contributions*	*Trust assets*
1977	$498,609	$504,966
1978	532,497	972,258
1979	328,916	1,231,433

In early 1977, the board of directors appointed the claims and investment committees created under the declaration of trust. The board selected its president (referred to elsewhere as the president of the corporation), the chairman of the investment advisory committee, ASMG's business administrator, and an independent attorney as the investment committee. The board selected its president, the chairman of the professional standards and review committee, an employee of trustee, and an independent attorney as the claims committee.

After establishment of the trust, each potential malpractice claim against an employee was referred to the claims committee. The claims committee, with the assistance of legal counsel and the acquiescence of the implicated employee, ultimately decided either to approve payment of the claim or to litigate the claim. ASMG paid all approved claims and submitted monthly statements detailing such claims to trustee. Trustee then reimbursed ASMG for such payments from trust funds. The trust was not licensed as an insurance company by the State of California.

During each of the years in issue, ASMG paid aggregate expenses slightly less than its gross income. Compensation and other benefits to employees, including physician employees who were also shareholders, constituted the majority of such expenses.

From 1976 through 1979, ASMG's total assets ranged between $1,072,542 in 1976 and $594,114 in 1978. The assets held by the trust were never reflected in ASMG's financial statements; with one immaterial exception, nor were trust assets ever considered in calculating the purchase or redemption price of ASMG shares, which was based upon ASMG's net asset value.

On its Federal income tax returns for 1977, 1978, and 1979, ASMG deducted as malpractice insurance expense the contributions to the trust.

The trust filed returns for 1977, 1978, and 1979 claiming an exemption from Federal income tax under section 501(c)(9). The trust paid no Federal income tax on the contributions from ASMG or on income from trust assets.

In the statutory notice of deficiency sent to ASMG, respondent determined that the amounts deducted by ASMG as malpractice insurance were not paid for ordinary and necessary business purposes. In the statutory notice of deficiency sent to the trust, respondent determined that the trust received taxable income in the forms of malpractice premium payments from ASMG and interest income. In his amended answer, respondent alleged that the trust was a grantor trust and that interest income received by the trust was therefore taxable to ASMG.

OPINION

Before 1977 petitioner ASMG, a medical professional corporation, purchased commercial insurance for malpractice claims arising from the acts of its employees. On December 31, 1976, ASMG established petitioner trust and thereafter contributed funds to the trust instead of purchasing commercial insurance. We must determine the proper tax treatment to ASMG and to the trust of the post-1976 arrangement.

1. Deductibility of the Contributions

Petitioners advance three arguments in support of the deductibility of the contributions by ASMG. Consistent with the position taken by ASMG on its tax returns, petitioners argue that the contributions constituted "malpractice insurance premiums." Petitioners alternatively assert that the contributions were deductible as payments to an employee benefit plan under section 1.162–10, Income Tax Regs. Finally, petitioners argue that the contributions were, in any event, "ordinary and necessary" business expenses within the meaning of section 162(a).

Insurance

Payments of insurance premiums are deductible from gross income under section 162, if the expenses are ordinary and necessary in the taxpayer's trade or business. Sec. 1.162-1(a), Income Tax Regs. Expenditures are deductible as insurance expenses, however, only if a true insurance arrangement exists. *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948 (1985); *Carnation Co. v. Commissioner*, 71 T.C. 400 (1978), affd. 640 F.2d 1010 (9th Cir. 1981). An insurance arrangement, in turn, necessarily involves both the shifting and the distributing of risk. *Helvering v. LeGierse*, 312 U.S. 531, 539–540 (1941); *Commissioner v. Treganowan*, 183 F.2d 288, 290 (2d Cir. 1950); *Tighe v. Commissioner*, 33 T.C. 557, 564 (1959).

> Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and insured each of whom gamble on the time the * * * [loss] will * * * [occur]. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its cost throughout a group. By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. * * * [Commissioner v. Treganowan, 183 F.2d at 291.]

Thus, there can exist no risk distribution without risk shifting. Because the arrangement between ASMG and the trust (which was not a licensed insurance company) did not accomplish real risk shifting, ASMG may not deduct the contributions to the trust as insurance premiums.

Petitioners argue that risk shifting occurred because—

> by its payments to the TRUST, ASMG has shifted to the TRUST its historically assumed obligation to provide malpractice protection for its employees. These employees, the sole beneficiaries of the TRUST, must correspondingly look solely to the TRUST for satisfaction of their responsibilities and liabilities to patients. In fact, as the evidence shows, patient claims have been, and will continue to be, satisfied from the TRUST.

Petitioners' argument ignores that, regardless of the extent of malpractice liability sustained by ASMG or its employees, the sole source of trust payments in satisfaction of such liability would be the contributions from ASMG (plus any income generated by the contributed funds). Under the declaration of trust and the amended employment contract, the trust would pay annual malpractice claims of up to $1 million per claim and $2 million per employee. During each of the years in issue, however, the trust's potential liability for payments far exceeded its funds. If actual claims in any year exceeded trust funds, ASMG would make additional contributions to the trust, to the extent of ASMG's available assets. Although the employment contract provided for the pro rata assessment against physician employees (to the extent of gross compensation), ASMG would be the entity making the additional contributions to the trust in the event of an insufficiency in trust assets. ASMG historically paid compensation to its physicians to the extent of available earnings, and the assessment provision merely allowed ASMG to determine physician compensation on a retrospective basis, i.e., taking into account actual claims experience. Petitioners' expert witness testified that trust funding was actuarially adequate during each of the years in issue. The fact remains, however, that ASMG would make additional contributions to the trust if actual claims were higher than actuarial assumptions.

Thus, like the taxpayer in *Carnation Co. v. Commissioner, supra,* ASMG has not shifted the risk of loss under the standard articulated in *Helvering v. LeGierse, supra,* and *Commissioner v. Treganowan, supra.* The taxpayer in *Carnation* attempted to deduct as casualty insurance premiums amounts paid to American Home, an independent insurance company, which reinsured 90 percent of the risk with Three Flowers, the taxpayer's wholly owned subsidiary. American Home agreed to the reinsurance arrangement only on the condition that Three Flowers, which the taxpayer initially capitalized with $120,000, have access upon demand to total capital contributions of $3 million from the taxpayer. Relying on *LeGierse,* we denied the taxpayer deductions for the premiums relating to the insurance risk that was assumed by Three Flowers. We reasoned as follows:

> In the event of a covered casualty, the loss suffered by Carnation ultimately would be borne 90 percent by Three Flowers and 10 percent by American Home. The agreement to purchase additional shares of Three Flowers by Carnation bound Carnation to an investment risk that was directly tied to the loss payment fortunes of Three Flowers, which in turn were wholly contingent upon the amount of property loss suffered by Carnation. The agreement by Three Flowers to "reinsure" Carnation's risks and the agreement by Carnation to capitalize Three Flowers up to $3 million on demand counteracted each other. Taken together, these two agreements are void of insurance risk. As was stated by the Court in *LeGierse,* "in this combination the one neutralizes the risk customarily inherent in the other." 312 U.S. at 541. [71 T.C. at 409.]

ASMG's agreement to make additional contributions to the trust is functionally equivalent to the agreement of the taxpayer in *Carnation* to make additional capital contributions to its subsidiary.

We stated in *Clougherty Packing Co. v. Commissioner,* 84 T.C. 948, 956 (1985), that the additional contribution agreement in *Carnation* was not essential to the result. "The test continues to be whether, considering all of the facts, the risk of loss was shifted away from the taxpayer who seeks to deduct insurance premiums." 84 T.C. at 957. We thus reached the same result as in *Carnation* despite the absence of an additional contribution agreement, based upon the parent and (second tier) subsidiary relationship between the taxpayer and the entity ultimately assuming the purported insurance risk. This does not mean, however, that the result in *Carnation* would have been different if the taxpayer and Three Flowers had been independent parties. Indeed, as we stated in *Carnation*, "The foregoing analysis of *LeGierse* reveals that the Court considered together two related agreements between *unrelated* parties." 71 T.C. at 408 (emphasis supplied). Although petitioners argue that *Clougherty Packing* and other "captive insurance company" cases[2] are inapplicable to their situation because ASMG did not possess the same dominion and control over the trust as a parent possesses over its subsidiary, the correctness of this factual assumption is in doubt and irrelevant. The contributory arrangement between ASMG and the trust alone indicates that risk of loss did not shift from ASMG to the trust.

In their reply brief, petitioners argue that the trust arrangement shifted risk from ASMG's employees to the trust:

> The whole purpose of the Trust was to assume the lion's share of the potential for malpractice liability of the employees of ASMG. * * * Thus, risk-shifting, from the primarily responsible employees to the Trust, has indisputably occurred.

Implicit in petitioners' argument is the conclusion that, but for the trust arrangement, the risk of loss from malpractice claims rested upon ASMG's employees, not ASMG itself. This conclusion simply is not true. Petitioners admit that under the doctrine of respondeat superior, ASMG was vicariously liable for the negligent acts of its employees. Because an employer has a right of indemnification against a negligent employee, the liability of the employer is secondary to that of the employee. See Cal. Lab. Code sec. 2865 (West 1971). But secondary liability is not the same as no liability. Under respondeat superior, a malpractice claimant could seek and receive full payment solely from ASMG. See Cal. Civ. Code sec. 2338 (West 1985). Indeed, in light of ASMG's substantial assets, including the monthly accounts receivable generated by its physicians, ASMG might represent the "deeper pocket." In that event, the inability of the negligent employee to reimburse ASMG would represent a potential loss, perhaps large enough to destroy ASMG. ASMG, the entity providing medical services to hospitals, could act only through its agents. Thus, for malpractice liability purposes, the protection of ASMG's employees cannot be separated from the protection of ASMG.[3]

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[2] See *Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985); *Beech Aircraft Corp. v. United States*, an unreported case (D. Kan. 1984, 54 AFTR 2d 84-6173, 84-2 USTC par. 9803); *Mobil Oil Corp. v. United States*, 8 Cl. Ct. 555 (1985); cf. *Crawford Fitting Co. v. United States*, 606 F. Supp. 136 (N.D. Ohio 1985).

Arguably, independent physicians, i.e., physicians not subject to common control of an employer, who establish an arrangement similar to that between ASMG and the trust might shift the risk of loss and thus create an "insurance" contract. See *United States v. Weber Paper Co.*, 320 F.2d 199 (8th Cir. 1963); the Commissioner's position in Rev. Rul. 83–172, 1983–2 C.B. 107, Rev. Rul. 80–120, 1980–1 C.B. 41, and Rev. Rul. 78–338, 1978–2 C.B. 107. That situation is not before us, however. The shareholders of ASMG, who formed the corporation and associated for business, undoubtedly took advantage of the substantial tax and other benefits available to professional corporations. They voluntarily chose to associate and they had a bona fide reason to establish the trust. But the reasonableness of their actions does not guarantee tax benefits. They cannot ignore the entity that they created or the tax disadvantages associated with it. Cf. *United States v. Basye*, 410 U.S. 441, 456 (1973); *Strong v. Commissioner*, 66 T.C. 12, 26 (1976), affd. without published opinion 553 F.2d 94 (2d Cir. 1977). This is not merely a matter of form versus substance. Formalities here reflect genuine differences in the legal relationships involved: ASMG's relationship to the trust is not the equivalent of ASMG's relationship to a commercial insurer. That one may be a functional substitute for the other does not control.

Employee Benefit Plan

Section 1.162–10(a), Income Tax Regs., provides:

> Sec. 1.162–10. Certain employee benefits.
>
> (a) *In general*. Amounts paid or accrued by a taxpayer on account of injuries received by employees and lump-sum amounts paid or accrued as

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[3] See *Humana Inc. v. Commissioner*, T.C. Memo. 1985–426.

> compensation for injuries are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business. However, except as provided in paragraph (b) of this section, such amounts shall not be deductible under section 162(a) if, under any circumstances, they may be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type referred to in section 404(a). In such an event, the extent to which these amounts are deductible from gross income shall be governed by the provisions of section 404 and the regulations issued thereunder.

Petitioners contend that the trust constitutes a "welfare or similar benefit plan" within the meaning of the above regulation and thus that ASMG may deduct contributions to the trust when made.

The regulation does not prescribe an exclusive list of benefit plans. Thus in *Greensboro Pathology Associates v. United States*, 698 F.2d 1196 (Fed. Cir. 1982), relied upon by petitioners, the Court of Appeals for the Federal Circuit held that an educational benefit plan for employees' children constituted a welfare or similar benefit plan. The court stated that the relevant inquiry was whether the plan was "one concerned with the well-being of the employees." 698 F.2d at 1200.[4]

The Court in *Greensboro Pathology* distinguished *Citrus Orthopedic Medical Group v. Commissioner*, 72 T.C. 461 (1979), in which we held that the employer had retained such extensive authority over the plan that the benefits purportedly conferred upon the employees were illusory. After noting that the plan in *Greensboro Pathology* was administered by an independent trustee and that the taxpayer retained no day-to-day control over trust funds, the Court of Appeals stated:

> We realize the appellant could at any time terminate or alter the plan although the monies of the trust could never revert to or inure to the appellant's benefit. This minimal retention of control is not sufficient to make the benefits of the plan in any way illusory. Employers need to retain rights to alter or terminate plans to meet the changing needs of the

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[4] The primary issue in *Greensboro Pathology Associates v. United States*, 698 F.2d 1196 (Fed. Cir. 1982), was whether the plan was a plan of deferred compensation and thus subject to sec. 404. See *Grant-Jacoby, Inc. v. Commissioner*, 73 T.C. 700 (1980). Respondent does not raise that issue herein.

> employees and employer. This flexibility may be required with numerous types of plans including the medical, vacation and other welfare benefit plans specified by regulation. *We hold that the critical inquiry is whether the funds in the plan may ever revert to or inure to the benefit of the company.* [*Greensboro Pathology Associates v. United States*, 698 F.2d at 1203 n.6. Emphasis supplied.]

In *Citrus Orthopedic*, the employer retained control over and responsibility for the investment and distribution of plan assets, could amend or terminate the plan at any time, and could require the return of all contributed funds. We therefore held that amounts contributed to the plan were not "paid or incurred" within the meaning of section 162(a). 72 T.C. at 467. In the present case, ASMG had control over the distribution of trust funds, i.e., ASMG had sole power to direct the payment of particular claims and to compel the purchase of commercial insurance. Trustee could not purchase taxable securities without the consent of ASMG, and ASMG retained the power to amend or terminate the trust. On termination, ASMG could direct distribution of the assets, although not to itself. The present case is distinguishable from *Citrus Orthopedic*, however, in that distributions were limited to the payment of malpractice claims and the purchase of malpractice insurance. Thus, unlike the employer in *Citrus Orthopedic*, ASMG could not recover directly its contributions to the trust.

We nevertheless conclude that the "critical inquiry" articulated in *Greensboro Pathology* whether the funds in the plan may ever revert to or inure to the benefit of the employer is integrally related to whether the plan is a welfare or similar benefit plan, i.e., one concerned with the well-being of the employees. To the extent that plan benefits may inure to the employer, the plan is concerned with the well-being of the employer, not of the employees.

As discussed above in connection with the insurance issue, the payment of malpractice claims from trust funds will discharge ASMG's liability to the claimants. Similarly, the purchase of commercial insurance with trust funds will protect ASMG from such liability. Thus, although the declaration of trust characterized the employees as the trust beneficiaries, trust funds may inure to the benefit of ASMG.

Trust distributions also benefit ASMG's employees, in satisfying or protecting loss from their liability on malpractice claims. The circumstances surrounding the creation of the trust nevertheless indicate that another purpose of the arrangement, at least equal in importance, was to benefit ASMG, the employer and provider of services. Establishment of the trust satisfied the security requirements of the California Board of Medical Quality Assurance and thereby insulated the *shareholders* of ASMG from joint and several liability. In justifying the amount of the annual contributions to the trust, ASMG's business administrator testified that "It would satisfy two requirements: one, our needs should there be a claim against Anesthesia Service and, two, afford us the security required by the Board of Medical Quality Assurance." Similarly, while providing comparable benefit for the physician employees, the trust arrangement allowed *ASMG* to continue *its* relationships with the hospitals *it* served, third-party health care providers, and the San Diego County Greater Health Plan, an organization to which ASMG belonged.

Malpractice liability plans are not specifically listed in section 1.162–10, Income Tax Regs. Based upon the entire record, we conclude that the trust was in substantial part and directly for the benefit of the employer, ASMG, and hence was not an employee "welfare or similar benefit plan."

Business Expenses

Petitioners further assert that, even if the contributions to the trust did not constitute insurance, the contributions were nevertheless deductible under "the general sweep of section 162." They contend that payments for malpractice protection were "ordinary and necessary" in ASMG's business.

Petitioners' argument attempts to circumvent the rule that expenditures are deductible as insurance premiums only if an insurance arrangement exists.[5] Indeed, our entire analysis of the insurance issue was predicated upon the assumption that the contributions were otherwise ordinary and necessary within the meaning of section 162(a). We do not doubt that the payment of either insurance premiums or actual malpractice claims by ASMG would be deductible under the statute. But the contributions to the trust were neither. They were instead equivalent to funds set aside for a future contingency, i.e., a reserve. Petitioners' argument would both eviscerate the insurance requirement and allow any cash basis taxpayer to obtain an immediate deduction for expenses to be paid in the future simply by transferring funds in trust. This latter effect is particularly inappropriate in the present case, where ASMG controlled the timing and amount of both the contributions to the trust and the payment of claims or insurance premiums by the trust.[6]

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[5] See *Humana Inc. v. Commissioner*, T.C. Memo. 1985–426.

Our holding is unaffected by the dramatic rise in commercial insurance rates, which prompted ASMG to establish the trust, or the obvious necessity of providing malpractice protection. The difficulty, or even impossibility, of obtaining commercial insurance is irrelevant to the issue before us. See *Stearns-Roger Corp. v. United States*, 774 F.2d 414 (10th Cir. 1985); *Clougherty Packing Co. v. Commissioner*, 84 T.C. 948, 958 (1985).

2. *Taxation of Trust Income*

Respondent indicated at trial that his determination that the trust was taxable on the contributions received from ASMG was alternative to his position with respect to the deductibility of the contributions by ASMG. Because we have upheld respondent's determination on the deductibility issue, the remaining issue is the taxation of the interest income generated by trust funds. Petitioners assert that the trust was a tax-exempt Voluntary Employees' Beneficiary Association (VEBA) or, alternatively, was taxable as an insurance company or an association. Respondent disputes these assertions and argues that the trust was a grantor trust, whose income is therefore taxable to ASMG.

VEBA Status

The organizations described in section 501(c), which are exempt from tax under section 501(a), include—

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[6] Cf. *Poirier & McLane Corp. v. Commissioner*, 547 F.2d 161 (2d Cir. 1976), revg. 63 T.C. 570 (1975). The undesirability of such a result was observed when Congress enacted secs. 419 and 419A in the Tax Reform Act of 1984, Pub. L. 98-369, sec. 511(a), 98 Stat. 494, 854-860. See H. Rept. 98-861 (Conf.) (1984), 1984-3 C.B. (Vol. 2) 1, 409. Sec. 419 limits the deduction for any contribution to a "welfare benefit fund" generally to the amount which would be deductible if the employer provided the benefits directly plus limited reserves for benefits specified in sec. 419A. These provisions are not effective for the years in issue.

> (9) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

Section 1.501(c)(9)–3, Income Tax Regs., defines the term "other benefits" as follows:

> (d) *Other benefits*. The term "other benefits" includes only benefits that are similar to life, sick, or accident benefits. A benefit is similar to a life, sick, or accident benefit if—
>
> (1) It is intended to safeguard or improve the health of a member or a member's dependents, or
>
> (2) It protects against a contingency that interrupts or impairs a member's earning power.
>
> (e) *Examples of "other benefits"*. Paying vacation benefits, providing vacation facilities, reimbursing vacation expenses, and subsidizing recreational activities such as athletic leagues are considered "other benefits". The provision of child-care facilities for preschool and school-age dependents are also considered "other benefits". The provision of job readjustment allowances, income maintenance payments in the event of economic dislocation, temporary living expense loans and grants at times of disaster (such as fire or flood), supplemental unemployment compensation benefits (as defined in section 501(c)(17)(D)(i) of the Code), severance benefits (under a severance pay plan within the meaning of 29 CFR sec. 2510.3–2(b)) and education or training benefits or courses (such as apprentice training programs) for members, are considered "other benefits" because they protect against a contingency that interrupts earning power. Personal legal service benefits which consist of payments or credits to one or more organizations or trusts described in section 501(c)(20) are considered "other benefits". Except to the extent otherwise provided in these regulations, as amended from time to time, "other benefits" also include any benefit provided in the manner permitted by paragraphs (5) *et seq.* of section 302(c) of the Labor Management Relations Act of 1947, 61 Stat. 136, *as amended*, 29 U.S.C. 186(c) (1979).
>
> (f) *Examples of nonqualifying benefits*. Benefits that are not described in paragraph (d) or (e) of this section are not "other benefits". Thus, "other benefits" do not include the payment of commuting expenses, such as bridge tolls or train fares, the provision of accident or homeowner's insurance benefits for damage to property, *the provision of malpractice insurance*, or the provision of loans to members except in times of distress (as permitted by sec. 1.501(c)(9)–3(e)). * * *
>
> [Emphasis supplied.]

Petitioners do not argue that the malpractice protection provided through the trust is outside the literal language of subsection (f) of the regulation. In this context, it appears that the term "the provision of malpractice insurance" includes self-insurance or other arrangements that are not true insurance for other purposes. Petitioners' argument is that the exclusion of malpractice insurance from "other benefits" by regulation is an invalid restriction on the statute.

The Supreme Court has articulated the following standard for determining the validity of Treasury regulations:

> regulations command our respect, for Congress has delegated to the Secretary of the Treasury, not to this Court, the task "of administering the tax laws of the Nation." *United States v. Cartwright*, 411 U.S. 546, 550, 93 S.Ct. 1713, 1716, 36 L.Ed.2d 528 (1973); accord, *United States v. Correll*, 389 U.S. 299, 307, 88 S.Ct. 445, 450, 19 L.Ed.2d 537 (1967); see 26 U.S.C. sec. 7805(a). We therefore must defer to Treasury Regulations that "implement the congressional mandate in some reasonable manner." *United States v. Correll, supra* at 307, 88 S.Ct. at 450; accord, *National Muffler Dealers Assn. v. United States*, 440 U.S. 472, 476–477, 99 S.Ct. 1304, 1307, 59 L.Ed.2d 519 (1979). To put the same principle conversely, Treasury Regulations "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501, 68 S.Ct. 695, 698, 92 L.Ed. 831 (1948); accord, *Fulman v. United States*, 434 U.S. 528, 533, 98 S.Ct. 841, 845, 55 L.Ed.2d 1 (1978); *Bingler v. Johnson*, 394 U.S. 741, 749–751, 89 S.Ct. 1439, 1444–1445, 22 L.Ed.2d 695 (1969). * * * [*Commissioner v. Portland Cement Co. of Utah*, 450 U.S. 156, 169 (1981).]

As petitioners correctly note, the regulation in issue was promulgated under the Treasury's general rule-making power in section 7805(a) and thus is entitled to less deference than a regulation "issued under a specific grant of authority to define a statutory term or prescribe a method of executing a statutory provision." *Rowan Cos. v. United States*, 452 U.S. 247, 253 (1981). See *United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 24 (1982); *First Charter Financial Corp. v. United States*, 669 F.2d 1342, 1346 (9th Cir. 1982). The term used by Congress, "other benefits," however, is extremely general and is not further defined. Further definition through an "interpretative" regulation is therefore particularly appropriate. Compare *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 476 (1979), *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U.S. 110, 114 (1939), and *Wang v. United States*, 757 F.2d 1000 (9th Cir. 1985), with *United States v. Vogel Fertilizer Co.*, 455 U.S. at 24, *Rowan Cos. v. United States*, 452 U.S. at 253, and *Bolton v. Commissioner*, 694 F.2d 556, 560–563 (9th Cir. 1982). The inquiry for the Court remains whether the regulation is consistent with the statute's plain language, origin, and purpose. *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. at 477.

Congress first enacted the predecessor to section 501(c)(9) and listed permissible benefits as "life, sick, accident, or other benefits" in the Revenue Act of 1928, ch. 852, sec. 103(16), 45 Stat. 791, 814. Although the provision has been modified several times, Congress has never altered the enumeration of permissible VEBA benefits. See Revenue Act of 1942, ch. 619, sec. 137, 56 Stat. 798, 836; Tax Reform Act of 1969, Pub. L. 91–172, sec. 121(b)(5), 83 Stat. 487, 541. The final regulations under section 501(c)(9) were filed on December 30, 1980, generally effective retroactively to taxable years beginning after December 31, 1954.[7] Thus the regulation in issue is not a contemporaneous interpretation of the statute. In this case, therefore,

> the manner in which * * * [the regulation] evolved merits inquiry. Other relevant considerations are the length of time the regulation has been in effect, the reliance placed on it, the consistency of the Commissioner's interpretation, and the degree of scrutiny Congress has devoted to the regulation during subsequent re-enactments of the statute. * * * [*National Muffler Dealers Association, Inc. v. United States*, 440 U.S. at 477.]

The legislative history of section 103(16) of the Revenue Act of 1928 is quite Spartan by current standards:

> Voluntary employees' beneficiary associations providing for the payment of life, sick, accident or other benefits to members and their dependents are common to-day, and it appears desirable to provide specifically for their exemption from the ordinary corporation tax. [H. Rept. 2, 70th Cong., 1st Sess. 17 (1928), 1939–1 C.B. (Part 2) 384, 395; S. Rept. 960, 70th Cong., 1st Sess. 25 (1928), 1939–1 C.B. (Part 2) 409, 426.]

In focusing upon organizations that were common at the time of enactment, however, this language is inconsistent with an all-inclusive definition of "other benefits." Indeed, until 1969 the Commissioner administered the VEBA provision without issuing regulations, primarily because most VEBAs were composed of small groups of local employees and provided very limited benefits. See Greenblatt, "New Prop. Regs. expand the use of voluntary employees' beneficiary associations," 53 J. Taxation 210, 211 (1980).

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[7] Sec. 1.501(c)(9)–8, Income Tax Regs. Petitioners do not challenge the general retroactivity of the regulations. Respondent, on the other hand, relies in part upon sec. 1.501(c)(9)–2(c)(3) of the regulations (requiring and defining employee control of the organization), which was not effective retroactively and hence which does not apply to the present case.

In 1969, the Commissioner issued proposed regulations under section 501(c)(9). 34 Fed. Reg. 1028 (1969). Although the proposed regulations defined "other benefits" similarly to the definition in the final regulations,[8] the proposed regulations did not specifically exclude malpractice insurance from the term. On July 17, 1980, the Commissioner withdrew the initial proposed regulations and issued new proposed regulations which defined "other benefits" identically to the final regulations. See 45 Fed. Reg. 47,874 (1980).

Congress re-examined the VEBA provisions in connection with the enactment of the Tax Reform Act of 1984. Although Congress did not amend section 501(c)(9), it limited employer deductions for contributions to all "welfare benefit plans" (see *supra* note 6), which include VEBAs, and subjected VEBAs to statutory nondiscrimination and notification requirements. Tax Reform Act of 1984, Pub. L. 98–369, sec. 513(a), 98 Stat. 494, 863–865 (enacting Code sec. 505). In explaining the new requirements, the House Ways and Means Committee, the Senate Finance Committee, and the Joint Taxation Committee each summarized "present law" governing VEBA status. With respect to permissible benefits, the report of the Ways and Means Committee stated:

> In general, a VEBA may provide life, sick, accident, or other benefits in cash or in kind to members or their dependents or beneficiaries.
>
> The regulations specify that "other" benefits means benefits similar to life, sick, or accident benefits. Under the regulations, such benefits must either (1) be intended to safeguard or improve the health of a member or a member's dependents or (2) protect against a contingency that interrupts or impairs a member's earning power. The following benefits are permissible "other" benefits that the regulations permit a VEBA to provide: (1) vacation benefits, (2) vacation facilities, (3) reimbursed vacation expenses, (4) subsidized recreational activities, (5) child care facilities for pre-school and school age dependents, (6) job readjustment allowances, (7) income maintenance payments in the event of economic dislocation, (8) temporary living expense loans and grants at times of disaster (such as fire or flood), (9) supplemental unemployment compensation benefits, (10) severance benefits, (11) personal

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[8] (v) Other benefits. The term "other benefits" include only benefits furnished to a member, his spouse or an individual specified in section 152(a) (even if more than 50 percent support is not furnished) which are similar to life, sick, and accident benefits. A benefit is similar to a life, sick, or accident benefit if it is intended to safeguard or improve the health of the employee or to protect against a contingency which interrupts earning power. * * * [34 Fed. Reg. 1029 (1969).]

> legal services, and (12) any benefit provided in the manner permitted under section 302(c)(5) et seq. of the Labor Management Relations Act of 1947.
>
> Impermissible VEBA benefits under the regulations include the following: (1) commuting expenses, (2) accident or homeowner's insurance benefits for damage to property, (3) malpractice insurance * * *
>
> [H. Rept. 98–432 (Part 2) 1286–1287 (1984). Fn. refs. omitted.]

The explanations of the Finance Committee and the Joint Committee contain virtually identical language. Senate Comm. on Finance, Explanation of Provisions Approved by the Committee on March 21, 1984 (Vol. 1) 317 (Comm. Print 1984); Staff of Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 796–797 (Comm. Print 1984).

Congress was thus well aware of, and characterized as existing law, the definition of "other benefits" contained in section 1.501(c)(9)–3, Income Tax Regs., and the exclusion of malpractice insurance from such benefits. Moreover, Congress did not attempt to change such existing law, even though it enacted substantial amendments affecting VEBAs. Indeed, nondiscrimination requirements were the subject of existing regulations (sec. 1.501(c)(9)–2(b), –4, Income Tax Regs.), but Congress, believing that such regulations were inadequate, enacted stricter statutory provisions (in new sec. 505). See H. Rept. 98–432 (Part 2) 1289 (1984); Senate Comm. on Finance, Explanation of Provisions Approved by the Committee on March 21, 1984 (Vol. 1) 319 (Comm. Print 1984); Staff of Joint Comm. on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 799 (Comm. Print 1984). We can only conclude that Congress believed the Treasury's definition of "other benefits" to be a reasonable interpretation of the statute. See *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 477 (1979).

Petitioners nevertheless advance an array of arguments against the regulation. They first assert that Congress never intended to limit "other benefits" to benefits similar to life, sickness, or accident benefits. Petitioners cite examples where Congress specifically utilized words such as "similar" or "like" to limit a collective category following a specific enumeration of items. See secs. 61(a)(1), 871(a)(1)(D). Petitioners' argument implies, however, that a VEBA can provide *any* employee benefit, a result which Congress could not have intended.

Given the breadth of the term "other benefits," the Treasury was not unreasonable in defining the term as benefits similar to life, sick, or accident benefits. See *National Muffler Dealers Association, Inc. v. United States*, 565 F.2d 845, 846 (2d Cir. 1977), affd. 440 U.S. 472 (1979).

Petitioners cite *Grange Insurance Association of California v. Commissioner*, 317 F.2d 222 (9th Cir. 1963), in which the Ninth Circuit Court of Appeals held that the term "life, sick, accident, or other benefits" in section 508(c)(8)(B) includes compensation for property damage as well as for personal injury. The court in *Grange Insurance* simply held that the common meaning of "accident" includes property damage and thus that the benefits in issue were "accident or other benefits." 317 F.2d at 224. The court did not, as petitioners assert, define literally the general term "other benefits." Moreover, the Treasury has not promulgated regulations defining the statutory term in issue in *Grange Insurance*. The issue before us, unlike the issue before the Ninth Circuit in *Grange Insurance*, is whether the regulation is consistent with the statute, not how we would interpret the statute in the absence of the regulation. "The choice among reasonable interpretations is for the Commissioner, not the courts." *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. at 488.

Petitioners finally argue that, even if similarity to life, sick, or accident benefits is the proper test for "other benefits," the regulation is internally inconsistent. According to petitioners, malpractice insurance better satisfies the alternative requirement for similarity, i.e., intended to safeguard or improve health or protecting against an interruption or impairment of earning power, than do many of the "permissible other benefits" listed in the regulation.

Protecting the employee from malpractice liability, however, necessarily entails protecting the employer. As this case illustrates, employer protection may be a dominant motive behind such arrangements, unlike the permissible other benefits listed in the regulation. Moreover, in contrast to malpractice protection, most of the specified other benefits enjoy express congressional approval in other areas of the tax law. See, e.g., sections 44 and 188 (child care), 120 and 501(c)(20) (legal services), 127 (educational assistance), 463 (vacation pay), 501(c)(7) (recreational organizations), and 501(c)(17) (supplemental unemployment compensation). The Treasury perhaps could have reasonably included malpractice insurance in "other benefits." Excluding malpractice protection from such benefits nevertheless was not unreasonable. Cf. *Bricklayers Benefit Plans v. Commissioner*, 81 T.C. 735 (1983); *Water Quality Association Employees' Benefit Corp. v. United States*, 609 F. Supp. 91 (N.D. Ill. 1985).

Even if the exclusion of malpractice insurance were an invalid restriction of the statute, employee participation in the trust was not "voluntary" as defined in section 1.501(c)(9)-2(c)(2), Income Tax Regs. That regulation provides, in relevant part:

> (2) *Voluntary*. Generally, membership in an association is voluntary if an affirmative act is required on the part of an employee to become a member rather than the designation as a member due to employee status. However, an association shall be considered voluntary although membership is required of all employees, provided that the employees do not incur a detriment (for example, in the form of deductions from pay) as the result of membership in the association. * * *

In the present case, all employees of ASMG become "members" of the arrangement solely by reason of their employment. Indeed, as the non-unanimous vote indicates, not even all shareholder employees wished to adopt the plan. All physician employees incurred a detriment as a result of membership in the plan. The $10,000 per physician contributions by ASMG reduced the amount of compensation ASMG otherwise could pay the physicians, and the physicians agreed to salary reductions if trust funds were inadequate to pay claims.

Taxation as an Insurance Company

Petitioners argue that, if the trust is not a VEBA, it is taxable as an insurance company, i.e., under subchapter L (sections 801 et seq.). Although the Internal Revenue Code does not define the term "insurance company," the regulations provide the following guidance:

> The term "insurance company" means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection

> to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code. [Sec. 1.801-3(a)(1), Income Tax Regs.]

As discussed above, the arrangement between ASMG and the trust did not constitute insurance, because risk shifting did not occur. The trust therefore is not an "insurance company" as defined in the above regulation. See *Allied Fidelity Corp. v. Commissioner*, 572 F.2d 1190, 1193–1194 (7th Cir. 1978), affg. 66 T.C. 1068 (1976); *Cuesta Title Guaranty Co. v. Commissioner*, 71 T.C. 278, 286–287 (1978), affd. without published opinion 639 F.2d 787 (9th Cir. 1981).[9]

Association versus Trust

Petitioners next contend that the trust constituted an association, which is included in the term "corporation" (section 7701(a)(3)), and not a trust for tax purposes.

An arrangement whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries constitutes a trust for tax purposes. Sec. 301.7701-4(a), Proced. & Admin. Regs. Regardless of State law classification, however, a trust arrangement created to carry on a profit-making business constitutes an association for tax purposes if, under section 301.7701-2, Proced. & Admin. Regs., the organization more nearly resembles an association than a trust. Sec. 301.7701-4(b), Proced. & Admin. Regs. Under section 301.7701-2(a)(2), Proced. & Admin. Regs., both associates and an objective to carry on business for joint profit are necessary for association status. See also *Morrissey v. Commissioner*, 296 U.S. 344 (1935); *Rohman v. United States*, 275 F.2d 120 (9th Cir. 1960); *Outlaw v. United States*, 494 F.2d 1376 (Ct. Cl. 1974).

In the present case, the objective of the trust, as expressed in the declaration of trust, was merely to receive funds from ASMG and, at ASMG's direction, to pay malpractice claims or insurance premiums. Thus, it in fact resembled a trust more than an association. Because it was merely an agent of ASMG with respect to a trust res and was not carrying on business for profit, the trust cannot be taxed as an association.

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[9] See also *Pariseau v. Commissioner*, T.C. Memo. 1985-124.

Grantor Trust Status

Because the trust was a trust and not an association for tax purposes, we must consider respondent's argument that the trust constituted a grantor trust whose income is taxable to ASMG.

Section 671 provides, in relevant part:

> Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. * * *

The term "grantor" includes a corporation. Sec. 1.671–2(e), Income Tax Regs.

Under section 677(a)(1), the grantor is treated as the owner of a trust if trust income may be distributed to the grantor in the discretion of the grantor or a nonadverse party. The discharge of a legal obligation of the grantor generally constitutes a distribution to the grantor. Sec. 1.677(a)–1(d), Income Tax Regs.

In the present case, trustee was a nonadverse party. Sec. 672(a), (b); sec. 1.672(a)–1, (b)–1, Income Tax Regs. Moreover, trust funds (including income) may be used to satisfy ASMG's legal obligation on malpractice claims resulting from acts of ASMG's employees. This case does not present the situation where the trust and not the grantor is primarily liable on the obligation. Compare *Wiles v. Commissioner*, 59 T.C. 289 (1972), affd. without published opinion 491 F.2d 1406 (5th Cir. 1974), with *Edwards v. Greenwald*, 217 F.2d 632 (5th Cir. 1954). The trust was therefore a grantor trust, and its income is taxable to ASMG.

We need not consider respondent's arguments with respect to other grantor trust provisions.

Conclusion

ASMG may not deduct amounts contributed to the trust, and trust income is taxable to ASMG. We have considered and rejected as either irrelevant or erroneous all other arguments raised by the parties. To reflect the foregoing,

Decision will be entered for the petitioner in docket No. 13935–83.

Decision will be entered for the respondent in docket No. 13936–83 in the amounts determined in the amended answer.

ESTATE OF EDWARD A. BOYD, JULIA H. BOYD AND MICHAEL E. BOYD, CO-PERSONAL REPRESENTATIVES, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 30219–82. Filed December 30, 1985.

Decedent's gross estate consisted of probate and nonprobate assets. The nonprobate assets included life insurance proceeds on decedent's life, payable to decedent's son. Decedent's will directed the estate's representatives to pay all Federal estate and State inheritance taxes imposed upon the gross estate, including tax imposed upon nonprobate property. Decedent's son, the sole beneficiary under the will, disclaimed his testate and intestate interests. The net probate estate passed by intestacy to decedent's surviving spouse and qualified for a marital deduction. *Held*: Decedent's son, the life insurance beneficiary, is not liable to the executor for payment of the Federal estate tax attributable to the life insurance proceeds under sec. 2206, I.R.C. 1954. The net probate estate that passed to decedent's surviving spouse is reduced by the amount of this estate tax liability, and the allowable marital deduction is decreased accordingly under sec. 2056. *Held, further*, the net probate estate and marital deduction are also reduced by the amount of the State inheritance tax imposed upon property that passed to the surviving spouse.

Arthur F. Lubke, Jr., and *John A. Herbers*, for the petitioner.
Edward J. Roepsch, for the respondent.

STERRETT, *Chief Judge*: Respondent determined a deficiency by notice dated October 5, 1982, of $34,497.04 in the Federal estate tax of petitioner. Respondent's amended answer determined an additional deficiency of $8,468.06. The deficiencies are based on reductions of the estate marital deduction.

After concessions, the primary issue for decision is whether the beneficiary of nonprobate life insurance proceeds was liable to the executor of the estate for payment of Federal estate tax attributable to the insurance proceeds. Also at issue is whether the marital deduction must be reduced for State inheritance tax imposed upon property that passed to the surviving spouse.

FINDINGS OF FACT

All of the facts have been stipulated and are so found. The stipulation of facts and supplemental stipulation of facts, together with the exhibits attached thereto, are incorporated herein by this reference.

Petitioner herein is the Estate of Edward A. Boyd. Edward A. Boyd (decedent) died testate on January 15, 1979, a resident of Wisconsin. Julia H. Boyd and Michael E. Boyd, co-personal representatives of the estate, filed a timely Federal estate tax return with the Internal Revenue Service Center, Kansas City, Missouri. The estate was administered in Wisconsin and the estate representatives resided in Wisconsin when the petition was filed.

The terms of decedent's will conveyed his entire estate to Virginia Rapp Boyd, decedent's former wife, but if she should fail to survive him, then to Michael Edward Boyd (decedent's son or the beneficiary). Decedent's former wife did predecease him, and decedent's son was the sole beneficiary under the will. Decedent was survived by his second wife, Julia H. Boyd (surviving spouse).[1]

Decedent's gross estate consisted of probate and nonprobate assets. The nonprobate assets included the proceeds of a life insurance policy on decedent's life, payable to decedent's son. Decedent's will provided that the estate and inheritance taxes payable because of his death were to be paid out of the general estate. This clause expressly included the tax attributable to nonprobate property within the gross estate, as follows:

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[1] The will was not revoked by decedent's subsequent marriage to Julia H. Boyd. Wis. Stat. Ann. sec. 853.11(2)(a) (West 1985).

> My Executrix or Executor, as the case may be, shall pay and discharge all my just debts and funeral and testamentary expenses out of my general estate, together with all estate and inheritance taxes (by whatever name called) becoming payable because of my death in respect of all property comprising my gross estate for death tax purposes, whether or not such property passes under this Will.

On July 12, 1979, decedent's son executed a document entitled "Disclaimer." On July 18, 1979, the estate representatives filed this document with the Wisconsin Probate Court that administered decedent's estate. It stated as follows:

> DISCLAIMER
>
> I, Michael E. Boyd, being the only issue of Edward A. Boyd and the only beneficiary under his will, pursuant to Wisconsin Statutes, section 853.40, irrevocably disclaim my entire interest under that will, including any right to have the probate estate pay any federal or Wisconsin estate or inheritance tax on any property passing to me outside the probate estate. I further disclaim any interest I may receive from the probate estate under any intestate law.
>
> I further certify that I have not received and have not accepted any of the interest which I am disclaiming or any benefits from that interest.
>
> Dated at Milwaukee, Wisconsin on July 12, 1979.
>
> (S) Michael E. Boyd
> MICHAEL E. BOYD

The disclaimer provided that decedent's son had disclaimed his testate and intestate interests. The net probate estate, as determined in accordance with the will provisions, passed by intestacy to decedent's surviving spouse.

Petitioner had computed the total Federal estate tax payable at $77,906.23. On January 28, 1980, petitioner received a $76,268.64 check from decedent's son, which he had intended to approximate the amount of estate tax imposed upon the life insurance proceeds. Petitioner forwarded this payment, plus its own check in the amount of $1,637.59, to respondent. Petitioner also paid to respondent $8,468.06 for Wisconsin inheritance tax imposed upon property which passed to the surviving spouse.[2]

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[2] Petitioner paid an additional $1,444.52 to respondent on June 8, 1981, based on a correction of a mathematical error made on the original estate tax return.

In the statutory notice of deficiency, respondent determined a deficiency of $34,497.04, based on a reduction in the net probate estate for Federal estate tax imposed on the nonprobate life insurance proceeds, which in turn decreased the allowable marital deduction. Respondent's amended answer determined an additional deficiency of $8,468.06 due to a decrease in the marital deduction for State inheritance tax.

OPINION

The primary issue for decision is whether the life insurance beneficiary is liable to the executor of the estate for payment of Federal estate tax attributable to certain nonprobate life insurance proceeds on decedent's life. The resolution of this issue will determine the amount of the net probate estate and allowable marital deduction.

Petitioner argues that the beneficiary has disclaimed the tax clause provision in decedent's will, so that the beneficiary is liable for the tax in accordance with section 2206.[3] Respondent argues that because of the tax clause, section 2206 is inapplicable, and the disclaimer does not operate to cause the beneficiary to become liable for this tax. Petitioner received a check from the beneficiary in an amount intended to approximate the estate tax attributable to the life insurance proceeds, which petitioner forwarded to respondent. However, it is immaterial that the beneficiary initially paid the tax upon the insurance proceeds. The issue remains whether the beneficiary or the estate was liable for this payment. *Estate of Haskell v. Commissioner*, 58 T.C. 197, 200 (1972), affd. 485 F.2d 679 (3d Cir. 1973). Petitioner bears the burden of proof on this issue. Rule 142(a).

The general rule is that the executor is liable for the payment of estate tax, including tax imposed upon property within the gross estate that is not in the executor's possession. Sec. 2002; sec. 20.2002-1, Estate Tax Regs. However, the executor may be entitled to recover the tax attributable to proceeds of a life insurance policy on the decedent's life which are receivable by a beneficiary other than the executor. Section 2206 provides, in part, that—

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[3] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect during the taxable year in question, and all Rule references are to the Tax Court Rules of Practice and Procedure.

> Unless the decedent directs otherwise in his will, if any part of the gross estate on which tax has been paid consists of proceeds of policies of insurance on the life of the decedent receivable by a beneficiary other than the executor, the executor shall be entitled to recover from such beneficiary such portion of the total tax paid as the proceeds of such policies bear to the taxable estate. * * *

Therefore, estate tax liability may be apportioned between the executor and the beneficiary. The statute does not impair respondent's right to collect the tax from the executor, nor does it require respondent to apportion the tax between the executor and beneficiary. Sec. 2205; secs. 20.2205-1 and 20.2206-1, Estate Tax Regs. The executor remains liable to respondent for payment in the first instance. However, as between the executor and the beneficiary, the executor may have the right to be reimbursed by the beneficiary. See *Estate of Haskell v. Commissioner*, 58 T.C. at 200; *Farley v. United States*, 217 Ct. Cl. 560, 581 F.2d 821 (1978); *Northern Trust Co. v. Baron*, 377 F. Supp. 666 (N.D. Ill. 1974); *Dodd v. United States*, 223 F. Supp. 785 (D.N.J. 1963), affd. 345 F.2d 715 (3d Cir. 1965).

The parties agree that decedent's will directed the executor to pay all the estate and inheritance taxes. Section 2206 expressly provides that a decedent may direct the apportionment of the tax burden on life insurance proceeds. Therefore, as a result of this "tax clause," section 2206 did not operate to impose this tax liability upon the beneficiary. Respondent takes the position that the beneficiary had no liability, statutory or otherwise, to pay to or reimburse the estate for the tax. However, petitioner argues that since the sole beneficiary under the will had disclaimed his entire testate interest, which created the intestate interest in decedent's surviving spouse, it is as if the decedent had died intestate. The parties acknowledge that if the decedent had died intestate, the beneficiary would have been liable for the tax under section 2206.

Section 2206 authorizes a decedent to direct that his estate may be liable for the tax attributable to life insurance proceeds. While it is true that the surviving spouse here is an intestate taker, her property interest is the net probate estate as determined under the will and therefore is subject to the tax clause. Wis. Stat. Ann. sec. 852.01(1) (West 1985). Therefore it is not as if the decedent died intestate, as petitioner claims. The question then becomes what effect, if any, did the beneficiary's disclaimer have upon the tax clause.

Petitioner also argues that based on State law, the beneficiary had executed a qualified disclaimer of this provision in decedent's will and, as a result, became liable for the tax at issue. Federal law has established that estate tax is paid out of the net estate, sec. 2205; State law generally determines who and what property shall bear the burden of the tax. However, exceptions to this determination under State law exist where there is a controlling Federal statute or contrary will provision, both of which are present in the instant case. *Riggs v. Del Drago*, 317 U.S. 95, 97–99, 101–102 (1942);[4] *Greene v. United States*, 476 F.2d 116, 118 (7th Cir. 1973); *Doetsch v. Doetsch*, 312 F.2d 323, 326–327 (7th Cir. 1963). We conclude that, under Federal law, the decedent's will directed that the executor of the estate would be liable for the payment of the tax and that the beneficiary would not be liable therefor. As a result, petitioner's argument that State law determined where the ultimate liability lies is misplaced. However, because petitioner purports that through State law the beneficiary had become liable for the tax in accordance with the Federal statute, we choose to address petitioner's argument.

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[4] The Supreme Court has stated—

"that Congress intended that the federal estate tax should be paid out of the estate as a whole, and that the applicable state law as to the devolution of property at death should govern the distribution of the remainder and the ultimate impact of the federal tax; * * * that Congress did not contemplate that the Government would be interested in the distribution of the estate after the tax was paid, and that Congress intended that state law should determine the ultimate thrust of the tax.[4] * * *

"[4] Congressman Cordell Hull, one of the supporters of the 1916 Act and its reputed draftsman, declared: 'Under the general laws of descent the proposed estate tax would be first taken out of the net estate before distribution, and distribution made under the same rule that would otherwise govern it. Where the decedent makes a will he can allow the estate tax to fasten on his net estate in the same manner, or if he objects to this equitable method of imposing it upon the entire net estate before distribution he can insert a residuary clause or other provision in his will, the effect of which would more or less change the incidence of the tax.' 53 Cong. Rec. 10657."

[*Riggs v. Del Drago*, 317 U.S. 95, 97–98 (1942).]

Also, the Supreme Court acknowledged that sec. 826(c), the predecessor of sec. 2206, authorizes a scheme of Federal apportionment in the instance of certain nonprobate property, such as life insurance proceeds includable in a decedent's gross estate. *Riggs v. Del Drago*, *supra* at 101–102.

Wisconsin courts acknowledge that Federal estate tax is imposed upon a decedent's whole estate. *Estate of Joas v. Langill*, 16 Wis. 2d 489, 114 N.W.2d 831, 833 (1962); *Uihlein v. Uihlein*, 264 Wis. 362, 59 N.W.2d 641, 646–648 (1951); *Kootz v. Wisconsin Tax Commission*, 228 Wis. 672, 280 N.W. 672, 675 (1938); *In Re Stephenson's Estate*, 171 Wis. 452, 177 N.W. 579, 580 (1920). There is no Wisconsin State apportionment statute. *Estate of Joas v. Langill, supra* at 833; *Uihlein v. Uihlein, supra* at 646. However, petitioner relies on *First Wisconsin Trust Co. v. Wisconsin Tax Commission* (*In Re Levalley's Estate*), 191 Wis. 356, 210 N.W. 941 (1926), where a will provision directed the executors to pay all estate and inheritance taxes imposed upon the will bequests. The court there equated the legatee's right to compel the executors to pay the State inheritance tax with a bequest. The court held that where the legatee was entitled to receive a "net legacy," that is, property free from its inheritance tax, that constituted a bequest, as a transfer of an interest in property, in the amount of the tax imposed. In order to prevail, petitioner first must establish that there was a transfer of property or of an interest in property. Sec. 2518; Wis. Stat. Ann. secs. 851.27 and 853.40 (West 1985).[5]

Petitioner's analogy to *Levalley's Estate* is misplaced. The bequest there was a legatee's relief from liability to pay a State inheritance tax. In the instant case, the primary issue is whether the beneficiary has become liable to pay Federal estate tax. This distinction is critical. State inheritance tax is imposed upon the recipient of a gift or transfer for the right to receive an interest in property. Federal estate tax is imposed upon an estate for the right to transfer an interest in property. *Estate of Murphy v. United States*, 524 F. Supp. 862, 864 (W.D. Wis. 1981); *Estate of Stevens v. Foster*, 74 Wis. 2d 1, 245 N.W.2d 673, 675 (1976); *Martinson v. Kellogg-Citizens National Bank* (*Estate of Bauknecht*), 49 Wis. 2d 392, 182 N.W.2d 238, 240 (1971). Inheritance tax is calculated for each gift or transfer based on the relationship between the parties, the amount of the gift or transfer, and the appropriate tax rate, which then is collected by the executor of the estate. *Estate of Bauknecht, supra* at 240, citing *Nunnemacher v. State*, 129 Wis. 190, 108

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[5] Based on our finding that there was no such transfer, we do not discuss the other elements of a qualified disclaimer under Federal or State law.

N.W. 627 (1906). Estate tax is determined upon the amount of the net estate at a unified rate. Sec. 2001; *Riggs v. Del Drago*, *supra* at 98–99 and n. 4.

In *Levalley's Estate*, since the legatee initially was liable for payment of the State inheritance tax, the will provision shifted this liability to the estate. This constituted an additional bequest which the legatee could either accept or reject. In the instant case, decedent's tax clause precluded the executor's right to require reimbursement from the beneficiary under section 2206. The beneficiary never bore the liability for this tax. He is not deemed to have received an additional bequest which would have constituted the requisite disclaimable interest. As a result, the disclaimer did not act to shift the incidence of tax liability to the beneficiary under section 2206. The beneficiary has attempted, unsuccessfully, to assume liability for the tax so as to increase the amount of the net probate estate and the marital deduction.

We conclude that petitioner has failed to establish that the beneficiary was liable for the estate tax attributable to the life insurance proceeds. As this tax was a liability of the estate, respondent properly reduced the net probate estate, which passed to the surviving spouse. The marital bequest is comprised of the net probate estate plus a nonprobate annuity to the surviving spouse. Sec. 2056(a). The amount of the marital deduction is based on the net value of the property interest which passes to the surviving spouse, after reduction for estate and other death taxes. Sec. 2056(b)(4)(A); sec. 20.2056(b)–4(a) and (c)(1), Estate Tax Regs.[6] We therefore uphold respondent's determination of this deficiency.

Respondent's amended answer raises an additional deficiency of $8,468.06, to be redetermined by the Court pursuant to section 6214(a). The deficiency is based on a reduction of the marital deduction for State inheritance tax imposed upon property passing to the surviving spouse. Respondent bears the burden of proof on this issue. Rule 142(a).

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[6] Sec. 20.2056(b)-4, Estate Tax Regs., provides in relevant part as follows:

Marital deduction; valuation of interest passing to surviving spouse—(a) *In general.* * * * The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, * * *

* * * * * * *

(c) *Effect of death taxes.* (1) In the determination of the value of any property interest which passed from the decedent to his surviving spouse, there must be taken into account the effect which the Federal estate tax, or any estate, succession, legacy, or inheritance tax, has upon the net value to the surviving spouse of the property interest.

Unlike Federal estate tax, liability for State inheritance tax lies initially with the beneficiary or recipient of the gift or transfer. *Estate of Haskell v. Commissioner*, 58 T.C. 197, 200 (1972); *Estate of Murphy v. United States, supra* at 864; *Estate of Stevens v. Foster, supra* at 675. However, a decedent may shift this tax burden where his intention to do so is expressed in clear language. *Estate of Murphy v. United States, supra* at 864; *Estate of Bauknecht, supra* at 240. In the instant case, the tax clause evidenced a clear expression of the decedent's intention to relieve his beneficiaries of liability for State inheritance tax. The representatives of the estate paid this tax on behalf of the surviving spouse and properly reduced the amount of the net probate estate and marital deduction for this liability. Sec. 2056(b)(4)(A). We conclude that the amount of the deficiency in petitioner's estate tax shall be redetermined based on this additional deficiency.

Decision will be entered under Rule 155.

ROBERT J. MILLER AND SUSAN F. MILLER, SAMUEL EDELMAN AND SYLVIA EDELMAN, PHILLIP PALEY AND DORENE PALEY, AND HAROLD W. PALEY, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 26986-83. Filed December 30, 1985.

Petitioners, as general partners, obtained recourse financing from an unrelated creditor and purchased a crane. The partnership entered into a short-term lease of the crane to petitioners' closely held corporation at a fair rental value. The partnership incurred ordinary and necessary expenses for maintenance and repair of the crane during the first 12 months of the lease term that exceeded 15 percent of the lease payments received from the lessee. *Held*, petitioners are entitled to investment tax

credits with respect to the crane pursuant to sec. 46(e)(3)(B), I.R.C. 1954.

Timothy C. Frautschi and *John A. Sanders*, for the petitioners.

Edward G. Langer, for the respondent.

OPINION

Swift, *Judge*: In timely statutory notices of deficiency, respondent determined deficiencies in petitioners' Federal income tax liabilities as follows:

Petitioners	*Year*	*Deficiencies*
Robert J. Miller and Susan F. Miller	1976 1979	[1]$5,805 60,877
Samuel Edelman and Sylvia Edelman	1979	9,024
Phillip Paley and Dorene Paley	1979	5,496
Harold W. Paley	1979	9,294

The sole issue for decision is whether petitioners, as noncorporate lessors, are entitled to investment tax credits with respect to a crane that was leased by them as partners to their closely held corporation.

All of the facts have been stipulated, and this case was submitted to the Court without trial pursuant to Rule 122, Tax Court Rules of Practice and Procedure. The petitioners in this case resided in Wisconsin when they joined in filing the petition herein. Petitioners timely filed their joint or individual Federal income tax returns for 1979.

Petitioners Robert J. Miller (Miller), Harold W. Paley, and Phillip Paley in 1979 were the sole shareholders of Miller Compressing Co., Inc. (hereinafter referred to as Compressing).[2] Miller served as chairman of Compressing's board of directors, and Harold W. Paley, Phillip Paley, and petitioner Samuel Edelman (Edelman) served as vice presidents of Compressing. Compressing was in the business of recycling scrap metal.

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[1] The deficiency determined for Robert J. Miller and Susan F. Miller for 1976 is attributable to the disallowance of an investment credit carryback from 1979 to 1976 in the amount of $5,805.

[2] Miller owned 93.2 percent of the stock of Compressing, Harold W. Paley owned 4 percent of the stock of Compressing, and Phillip Paley owned 2.8 percent of the stock of Compressing.

In 1979, Miller, Edelman, Harold W. Paley, and Phillip Paley (hereinafter collectively referred to as petitioners) formed the 850 Company, a Wisconsin general partnership (hereinafter referred to as the partnership).[3] None of the partners contributed capital to the partnership. The partnership and Compressing maintained their principal places of business at the same location, and the partnership had no employees in 1979.

In June of 1979, the partnership signed a full recourse loan agreement with the Marine National Exchange Bank of Milwaukee, Wisconsin (hereinafter referred to as the bank), in the amount of $451,225. The loan agreement reflected a variable interest rate of 1.5 percent above the prevailing prime interest rate. Petitioners were jointly and severally liable as individuals for the full amount of the loan. The partnership had contacted two other lenders, but the partnership accepted the bank's loan offer because it reflected a lower interest rate than the rates offered by the other lenders.

The loan proceeds were used to purchase an American Hoist & Derrick Model 850 DEH Diesel Electric Motor Crane and one 78-inch Deepfield Scrapmaster Electric Magnet (both of which hereinafter are referred to as the crane). The purchase price for the crane was $451,225. On or about June 11, 1979, the partnership agreed to lease the crane to Compressing for a term of 7 years and 5 months or 49.5 percent of the useful life of the Crane, whichever was less. The annual lease payment was $90,000.

Under the lease agreement, the partnership, as lessor, was responsible for the operating and maintenance expenses of the Crane during the first 12 months of the lease until the amount of such expenses incurred by the partnership equaled 16 percent of the total lease payments due from Compressing during the first 12 months of the lease. After the partnership had incurred expenses in that amount, the lease agreement provided that Compressing, as lessee, was responsible for all

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[3] The partnership agreement provided that net profits and net losses of the partnership would be allocated as follows:

Miller	74%
Edelman	10
Harold W. Paley	10
Phillip Paley	6

expenses of operating the Crane, including expenses for maintenance, repair, and insurance. Paragraph 5 of the lease provided as follows:

> 5. *Service and Insurance During First Twelve Months*: During the first twelve months of the Term, Lessor [Partnership] shall pay for and provide all electric power, fuel, oil and lubricants consumed by and required for the [Crane], all repairs, parts and supplies necessary therefor, and all of the insurances provided for in paragraph 8 hereof, until the total amount expended by Lessor for all of the aforementioned purposes shall equal sixteen percent (16%) of the total of the Rentals and Impositions payable by Lessee [Compressing] hereunder for such twelve-month period. Thereafter, all such expenses shall be borne exclusively by Lessee as provided in paragraphs 6 and 8 hereof.

The parties have stipulated that petitioners believed that the partnership's purchase and lease of the crane to Compressing would be a good economic investment for the partnership, that petitioners anticipated that rental income from the lease would exceed loan payments, and that the crane would "retain its value" throughout the term of the lease. Also, it has been stipulated that in 1979 a resale market existed for the particular type of crane and magnet leased by the partnership to Compressing.

At the beginning of the lease term in 1979 and at petitioners' request, the accountant for the partnership prepared a projection of income and expenses with respect to the lease using an annual interest rate of 11 percent[4] and a residual value for the crane at the end of the lease term equal to 45 percent of its cost. That projection, excluding tax benefits, demonstrated that the residual value of the crane would exceed the remaining balance of the loan and that there would be positive cash flow over the term of the lease. In fact, however, the prime interest rate during the term of the lease rose to a high of 21.5 percent. Because the lease provided a fixed rental payment that was not linked to the variable interest rate charged on the loan, the partnership's loan payments exceeded rental income from the lease, and the lease was not profitable for the partnership.

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[4] In December of 1978, the prime interest rate charged by commercial banks was 11.75 percent and in June of 1979, it was 11.5 percent. See D. Thorndike, Encyclopedia of Banking and Financial Tables—1985 Yearbook, part II, at 2 (1985).

The lease was beneficial to Compressing in that it allowed Compressing to obtain the use of the crane without incurring additional debt. The lease also gave Compressing an option to purchase the crane at the end of the lease term at the Crane's then fair market value.

During the first 12 months of the lease, the partnership paid $19,941.09 for maintenance, repair, and insurance expenses of the crane, an amount which exceeded 15 percent of the lease payments during the first 12 months of the lease. Compressing made lease payments to the partnership when due.

The partnership investigated and considered the purchase and leasing of additional cranes, and in September of 1980, it purchased a second crane which also was leased, on similar terms, to Compressing. The partnership suspended its search for additional leasing opportunities upon the initiation by respondent of the audits of petitioners wherein respondent challenged petitioners' claims to investment credits with respect to the crane that was purchased in 1979.

Section 38 and section 46,[5] among other things, allow Federal income tax credits for investments in certain tangible personal property, referred to as "section 38 property" and defined in section 48(a). Additional credits are allowed for investments in certain recycling equipment, referred to as "energy property" and defined in section 48(1). Sec. 46(a).[6] The parties agree that the crane qualifies as section 38 property pursuant to section 48(a), and as energy property pursuant to section 48(1).

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[5] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as in effect during the years in dispute.

[6] Sec. 46 provides in relevant part:

SEC. 46(a). GENERAL RULE. * * *

* * * * * * *

(2) AMOUNT OF CREDIT.—

(A) IN GENERAL.—The amount of the credit determined under this paragraph for the taxable year shall be an amount equal to the sum of the following percentages of the qualified investment (as determined under subsections (c) and (d)):

(i) the regular percentage,

(ii) in the case of energy property, the energy percentage, and

(iii) the ESOP percentage.

(B) REGULAR PERCENTAGE.—For purposes of this paragraph, the regular percentage is 10 percent.

(C) ENERGY PERCENTAGE.—For purposes of this paragraph, the energy percentage is—

(i) 10 percent with respect to the period beginning on October 1, 1978, and ending on December 31, 1982 * * *

At issue herein are certain limitations on the allowance of investment credits to noncorporate lessors. Investment credits are not available to a noncorporate lessor unless property subject to the lease was manufactured or produced by the noncorporate lessor as provided in section 46(e)(3)(A), or unless the lease qualifies as a short-term lease under section 46(e)(3)(B). It is upon this latter provision that petitioners rely in their contention that the lease of the crane qualifies for the investment credits at issue herein.

Section 46(e)(3)(B) sets forth two tests, both of which must be met in order for a noncorporate lessor, under that provision, to be entitled to investment credits with respect to property leased under a short-term lease. First, the term of the lease must be less than 50 percent of the useful life of the property (hereinafter referred to as the 50-percent useful life test). Second, the lessor, during the first 12 months of the lease, must incur ordinary and necessary expenses related to the leased property in an amount that exceeds 15 percent of the lease payments received during the first 12 months of the lease (hereinafter referred to as the 15-percent expense test). Section 46(e)(3)(B) provides as follows:

> SEC. 46. AMOUNT OF CREDIT.
>
> (e) LIMITATIONS WITH RESPECT TO CERTAIN PERSONS.— * * *
>
> (3) Noncorporate lessors.—A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if—
>
> * * * * * * *
>
> (B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

The parties agree that the term of the lease at issue herein was less than 50 percent of the useful life of the crane. The parties further agree that the expenses incurred by the partnership, as lessor, for maintenance, repairs, and insurance of the crane during the first 12 months of the lease were ordinary and necessary expenses and totaled an amount in excess of 15 percent of the lease payments received during the first 12 months of the lease.

Respondent, however, contends that the 15-percent expense test of section 46(e)(3)(B) requires not only that the expenses paid by the noncorporate lessor during the first 12 months of the lease be ordinary and necessary expenses of leasing the equipment and that they constitute an amount in excess of 15 percent of the lease payments during the first 12 months of the lease, but also that the noncorporate lessor independently must establish that he was engaged in the trade or business of leasing and that the particular lease in question was a part of that trade or business. Respondent relies on the reference in section 46(e)(3)(B) to "section 162 expenses" and argues that that reference to section 162 implicitly requires a finding both that the expenses were ordinary and necessary *and* that the noncorporate lessor was in the trade or business of leasing.[7]

Respondent argues further that petitioners formed the partnership and structured the lease transaction in question merely to provide the individual petitioners herein with substantial tax credits and deductions in order to reduce their Federal income tax liabilities. Respondent suggests that section 46(e)(3)(B) was enacted with the specific legislative intention to deny such tax benefits to individuals or groups who seek to utilize the tax benefits of leasing to shelter from tax a substantial part of their other income.

Petitioners respond with equal vigor. They assert (1) that Congress chose to make the availability to noncorporate lessors of investment credits with respect to short-term leases dependent upon the satisfaction of the two objective tests provided in section 46(e)(3)(B) as those two tests are applied to a particular lease; (2) that there is no trade or business test in section 46(e)(3)(B) beyond the two objective tests; and (3) in the alternative, that if there is an additional trade or business test in section 46(e)(3)(B), the partnership satisfied that test by virtue of its participation in the lease in question. Petitioners argue further that no inquiry into petitioners' subjective intent or motive in entering into the lease is necessary or required under the statute. Petitioners emphasize that the lease was a bona fide business transaction and that the loan was negotiated with independent creditors.

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[7] Sec. 162(a) provides, in part, as follows:

SEC. 162(a). IN GENERAL.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

Further, petitioners contend, the lease imposed a fair rental charge for the use of the crane, and petitioners reasonably expected that the lease would be profitable to the partnership. For the reasons explained below, we agree with petitioners.

The legislative history of section 46(e)(3)(B) explains that the purpose of the two objective tests set forth therein was to establish when a particular lease transaction would be considered to constitute a business activity of the taxpayer, as well as to establish when a noncorporate lessor would be able to claim investment credits with respect thereto. The House report explains that the bill provides, in general, for the allowance of the credit in the case of short-term leases—

> *since in these cases the leasing activity constitutes a business activity* of the taxpayer, rather than a mere investment, i.e., a financing arrangement. * * * [H. Rept. 92–533 (1971), 1972–1 C.B. 498, 513. Emphasis supplied.]

In other words, if a particular lease qualifies as a short-term lease under the two objective tests, it will be regarded as constituting a business activity of the taxpayer, not a mere passive investment, and it will qualify for the applicable investment credits. The above explanation in the House report strongly supports petitioners' position that the statute requires only that a particular lease meet the two objective tests of section 46(e)(3)(B).

The House report further explains that the reason two objective tests were established in section 46(e)(3)(B) is that if those tests are met "the lease is quite likely to represent a normal *business* transaction of the lessor rather than a passive investment entered into for the purpose of sheltering income." H. Rept. 92–533 *supra*. (Emphasis supplied.) That explanation also supports the conclusion that where a particular lease transaction satisfies the two objective tests of section 46(e)(3)(B), Congress intended that the lessor would be considered to be engaged in the business of leasing.

The manner in which the 15-percent expense test is to be calculated under the statute further supports petitioners' interpretation of section 46(e)(3)(B). The expenses paid by the noncorporate lessor only with respect to a particular lease are to be compared with the noncorporate lessor's income from that lease during the first 12 months of the lease. Sec. 46(e)(3)(B); sec. 1.46–4(d)(3)(i), Income Tax Regs. That calculation clearly ignores the lessor's "other" activities (whether passive investment or trade or business) and requires a separate calculation and a separate determination for each lease. Furthermore, the calculation of the 15-percent expense test is based only on the first 12 months of the lease, which suggests that satisfaction of that test is not dependent upon the noncorporate lessor's trade or business activities beyond the particular lease in question.

In summary, the 15–percent expense test of section 46(e)(3)(B) focuses on each particular lease in question and then only on the first 12 months thereof. That approach refutes respondent's argument that Congress intended a noncorporate lessor to be subject to an additional trade or business test which would raise questions concerning the lessor's activities beyond the particular lease in question.

Respondent relies upon statements in the legislative history to the effect that Congress' general objective in enacting the limitations of section 46(e)(3)(B) was to limit the allowance of investment credits to noncorporate lessors who conducted an "active business" and who were not just passive investors. See H. Rept. 92–533, *supra*, 1972–1 C.B. at 513; S. Rept. 92–437 (1971), 1972–1 C.B. 559, 583. That general objective is undisputed. Respondent confuses the general legislative objective with the manner in which Congress chose to implement that objective. The question before us centers not on the general legislative objective, but on whether that objective was implemented by enactment in section 46(e)(3)(B) of a two-pronged objective test relating to a particular lease, or by enactment of that test plus an additional test relating to the noncorporate lessor's other trade or business activities. As indicated, we conclude that the former was Congress' intent.

For the reasons explained above we believe that the reference in section 46(e)(3)(B) to "section 162" simply describes the *type* of ordinary and necessary expenses that are to be included in making the calculation of the 15-percent expense test. The reference therein to section 162 does not require the noncorporate lessor to satisfy an additional trade or business test.[8] As we stated in *Ridder v. Commissioner*, 76 T.C. 867, 876 (1981), in discussing the 50-percent useful life test of section 46(e)(3)(B)—

> In drafting section 46(e)(3)(B), * * * Congress decided to impose two hard-and-fast tests * * *. In effect, Congress chose a more easily administered approach (which, for taxpayers, provides predictability) and sacrificed some small measure of perfect equity. Not only was this choice at least arguably reasonable, it is not for us in any case to pass upon the wisdom of legislation. [Citations omitted.]

We conclude that there is no trade or business test in section 46(e)(3)(B) beyond the two objective tests set forth therein.

We do not dispute respondent's contention herein that even though an agreement may take the form of a lease which meets the objective tests of section 46(e)(3)(B), in appropriate circumstances, such a lease still may be scrutinized, and, if lacking in substance, the lease may be disregarded as a sham. *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978); *Knetsch v. United States*, 364 U.S. 361 (1960); *Braddock Land Co. v. Commissioner*, 75 T.C. 324, 329 (1980).

We cannot agree with respondent's assertion, however, that the lease under consideration herein was lacking in economic substance or business purpose. The partnership negotiated at arm's length with an unrelated bank a full recourse note for the purchase price of the crane, under which petitioners were jointly and severally liable. Petitioners had a reasonable expectation of making a profit from the lease of the crane. Based upon the projections calculated by their accountant, and excluding possible tax advantages, petitioners estimated that rental payments over the term of the lease would exceed by $81,000 the sum of petitioners' debt service on the note and the maintenance, repair, and insurance expenses incurred by the partnership with respect to the crane. The lease also was of economic benefit to Compressing because it allowed Compressing to avoid additional debt.

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[8] A comment is appropriate with regard to the additional argument made by respondent that since the expenses incurred by the partnership with respect to the crane would have been deductible under both secs. 162 and 212, those expenses do not meet the requirement of sec. 46(e)(3)(B) in that they were not deductible "solely" by reason of sec. 162. This argument fails to take into account the symbiotic relationship between sec. 162 and sec. 212 and the fact that most, if not all, expenses that are deductible under sec. 162 also are deductible under sec. 212. Therefore, if respondent's argument on this point were correct, no lease would qualify under sec. 46(e)(3)(B) since the ordinary and necessary expenses related to the lease would be deductible under both sec. 162 and sec. 212.

We are not required to adopt an interpretation of a statute that is contrary to its clear purpose and that leads to absurd results. *United States v. American Trucking Associations, Inc.*, 310 U.S. 534, 543 (1940); *Hodgson v. Board of County Commissioners, County of Hennepin*, 614 F.2d 601, 612 (8th Cir. 1980); *Lastarmco, Inc. v. Commissioner*, 79 T.C. 810, 826–827 (1982), affd. 737 F.2d 1440 (5th Cir. 1984). Sec. 1.46-4(d)(3)(ii), Income Tax Regs., enumerates the type of ordinary and necessary expenses that do not count in the computation of the 15-percent expense test, as follows:

> depreciation allowable by reason of section 167 (including amortization allowable in lieu of depreciation); interest allowable by reason of section 163; taxes allowable by reason of section 164; and depletion allowable by reason of section 611 are examples of deductions which are not taken into account in applying the test. * * *

No mention is made in the regulation to expenses deductible under sec. 212 because it would be inappropriate to do so. Clearly, even though expenses may be deductible under both sec. 162 and sec. 212, they may be counted in the determination of whether the 15-percent expense test is met.

Respondent contends that the lease was merely a financing arrangement and that it involved no entrepreneurial risk on the part of petitioners. Whether a lease agreement is in substance a financing arrangement is dependent upon the intent of the parties as evidenced by the provisions of the agreement read in light of all the facts and circumstances existing at the time the agreement was executed. *Western Contracting Corp. v. Commissioner*, 271 F.2d 694, 701–702 (8th Cir. 1959); *Northwest Acceptance Corp. v. Commissioner*, 58 T.C. 836, 844–850 (1972), affd. 500 F.2d 1222 (9th Cir. 1974). Such factors as the short-term nature of the lease agreement, the lessee's fair market value purchase option, and the full recourse liability of the general partners on the loan support our conclusion that the lease in question was not merely a financing arrangement, but that petitioners herein negotiated a bona fide lease at terms they expected would return to the partnership a reasonable profit.

Further, even if there were a separate trade or business test in section 46(e)(3)(B) beyond the two objective tests, we would find for petitioners herein. The maintenance, repair, and insurance expenses incurred by the partnership with respect to the crane are the type of ordinary and necessary expenses typically incurred in the active conduct of a trade or business. It is settled that a taxpayer may be engaged in a trade or business even where the taxpayer rents or leases only one property or piece of equipment. See *Curphey v. Commissioner*, 73 T.C. 766, 774 (1980); *Fegan v. Commissioner*, 71 T.C. 791, 814 (1979), affd. in an unreported decision (10th Cir. 1981); *Elek v. Commissioner*, 30 T.C. 731, 733 (1958); *Lagreide v. Commissioner*, 23 T.C. 508, 512 (1954); *Hazard v. Commissioner*, 7 T.C. 372, 375 (1946).[9] The partnership herein was engaged in the trade or business of leasing, and the ordinary and necessary expenses incurred in connection with the lease of the crane were deductible by reason of section 162.

In view of the foregoing, petitioners are entitled to the investment tax credits claimed with respect to the lease of the Crane.

Decision will be entered under Rule 155.

ATLANTIC VENEER CORPORATION, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2870–83. Filed December 31, 1985.

Petitioner purchased a limited partnership interest in a German partnership, effective Jan. 1, 1973. The German partnership stepped up the basis of its assets, as required by German law, to take into account the amount by which the petitioner's purchase price exceeded the adjusted basis of its allocable share of the German partnership's assets. In its June 30, 1974, fiscal year U.S. tax return, petitioner reported its distributive share of income of the German partnership for calendar year 1973, which was computed by using the stepped-up basis for purposes of depreciation. To that return, petitioner attached a copy of the 1973 German partnership return and schedules without any English translations. *Held*, the required election was not made which would permit petitioner to have the benefit of the adjustments to basis pursuant to the provisions of secs. 754 and 753, I.R.C. 1954.

Dennis I. Meyer, *Bertrand M. Harding, Jr.*, and *Thomas A. O'Donnell*, for the petitioner.

Kristine A. Roth and *Marlene Gross*, for the respondent.

TANNENWALD, *Judge*: Respondent determined the following deficiencies in petitioner's Federal income taxes:

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[9] See also Rev. Rul. 78–144, 1978–1 C.B. 168; Rev. Rul. 60–206, 1960–1 C.B. 201.

Taxable year	*Deficiency*
1976	$102,784.30
1977	115,452.54
1978	145,469.77

The sole issue for decision is whether a valid election was filed pursuant to section 754[1], thus permitting petitioner to benefit from an adjustment to the basis of partnership property under section 743(b).[2]

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. This reference incorporates the stipulation of facts and attached exhibits.

Petitioner, a North Carolina corporation, had its principal place of business in Beaufort, North Carolina, at the time it filed its petition in this case. Petitioner timely filed its Federal corporate income tax returns for the taxable years ending June 30, 1974, through June 30, 1978, with the Internal Revenue Service Center in Memphis, Tennessee. In addition, petitioner filed amended corporate income tax returns for the taxable years ending June 30, 1974, and June 30, 1976.

On December 29, 1972, petitioner entered into a contract with two limited partners of K. Heinz Mohring (KG), a limited partnership organized under the laws of the Federal Republic of Germany (the German partnership), to purchase their combined one-third interest in the German partnership, effective January 1, 1973. The purchase price paid by petitioner was approximately $5,270,000, which exceeded by approximately $3,255,000 the adjusted basis of petitioner's allocable share of the German partnership's assets as of the January 1 acquisition date. Pursuant to German law, on its books and in its tax returns filed with the Federal Republic of Germany, the German partnership increased petitioner's basis in its share of the partnership's assets by the aforementioned $3,255,000 and allocated such excess amount among the partnership's assets owned as of January 1, 1973.[3]

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[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

[2] The statutory notice of deficiency issued to petitioner made several adjustments to petitioner's income for the taxable years in question. Petitioner conceded the correctness of all of these adjustments except the disallowance by respondent of depreciation deductions which were based upon petitioner's use of a stepped-up basis in partnership property. With respect to such use, respondent disallowed depreciation deductions of $62,976.48, $66,307.27, and $282,724.25 for the taxable years 1976, 1977, and 1978, respectively.

During its taxable years 1973 through 1978, the German partnership carried on no trade or business within the United States and derived no income from sources within the United States. The German partnership filed neither a U.S. partnership return Form 1065 nor a statement electing stepped-up treatment under section 743(b) with the Internal Revenue Service during this period. Under the German partnership's Articles of Partnership, the limited partners were not authorized to represent the partnership without a special power of attorney. No such special power of attorney was ever requested by or granted to petitioner that would have permitted it to file a U.S. tax return on behalf of the German partnership.

The first taxable year for which petitioner was required to report any distributive share of income or loss from the German partnership was petitioner's taxable year ending June 30, 1974. Petitioner reported on its corporate income tax return Form 1120 for each of its taxable years from 1974 through 1978 its distributive share of income from the German partnership, which was computed using the stepped-up basis in the partnership assets. Petitioner attached to each corporate return a copy of the German tax return of the German partnership, with attached schedules, for the German partnership's year ending December 31 of the preceding year. These partnership returns were in German, and petitioner did not provide translations of any portion of them to the Internal Revenue Service.[4] However, each Form 1120 contained a schedule which clearly identified petitioner's distributive share of the German partnership's income, the exchange rate utilized by petitioner in converting from Deutsche marks to

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[3] Contrary to the optional election available to taxpayers in the United States under sec. 754, German law mandates an automatic step up in basis of partnership assets when a partnership interest is transferred.

[4] There was some question at trial whether petitioner had in fact ever attached to its corporate returns translations of the German partnership's returns. We held the record open for 30 days to give petitioner an opportunity to check its files to see if such translations had actually been provided to the Internal Revenue Service. Petitioner, by letter dated May 18, 1984, advised this Court that a review of its files, and of those of petitioner's certified public accountants, revealed that no English translations had been included with the Form 1120 filed by petitioner in each of the taxable years in question.

U.S. dollars and a direct reference to the page in the attached German tax return that evidenced this distributive share.

Each German partnership tax return included a document entitled "Enclosure to the Profit Assessment Statement." On page 2 of the "Enclosure to the Profit Assessment Statement 1973" was a schedule entitled "Supplementary Balance for Tax Purposes as of December 31, 1973" (enclosure), which pertained only to petitioner and listed as the value of each of the German partnership's assets as of January 1, 1973, the amount by which petitioner's basis in its partnership interest in the German partnership immediately after its acquisition of such interest exceeded petitioner's allocable adjusted basis in each of the German partnership's assets. The return of the German partnership containing said schedule was attached to petitioner's Form 1120 for the taxable year ended June 30, 1974. An English translation of the enclosure[5] revealed that the German partnership did in fact step up the basis of the partnership's assets to reflect the excess of petitioner's purchase price over the allocable adjusted basis in each of the German partnership's assets prior to petitioner's acquisition.

The corporate tax returns of petitioner filed for the taxable years ending June 30, 1974, and June 30, 1975, were never audited by respondent. Other than requests for statements and information made during the course of the audit leading to the issuance of the statutory notice of deficiency in this case, at no time during the taxable years in question did respondent exercise his authority under section 1.6031-1(d)(2), Income Tax Regs., to require petitioner to render statements or other information to determine whether petitioner was liable for a tax on income from the German partnership, nor has he ever questioned the accuracy or legitimacy of the allocation computations on the partnership returns.

OPINION

Under section 743(b), a partner who acquires a partnership interest at a purchase price in excess of the adjusted basis of his allocable share in the partnership's assets is permitted to step up the basis of these assets if the partnership so elects under section 754.[6] Pursuant to section 754—

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[5] During the audit, respondent obtained certified English translations of each of the German partnership's returns from the Language Services Division, U.S. Department of State.

> If a partnership files an election, in accordance with regulations prescribed by the Secretary, the basis of partnership property shall be adjusted, * * * in the case of a transfer of a partnership interest, in the manner provided in section 743. * * *

In order to make a valid election, the regulations promulgated under section 754 clearly state that "An election * * * shall be made in a *written statement filed with the partnership return* for the taxable year during which the distribution or transfer occurs."[7] Sec. 1.754-1(b)(1), Income Tax Regs. (emphasis added).

Turning to the partnership information return requirements of section 6031(a), that section provides that—

> Every partnership (as defined in section 761(a)) shall make a return for each taxable year, stating specifically the items of gross income and the deductions allowable by subtitle A, and such other information for the purpose of carrying out the provisions of subtitle A as the Secretary may by forms and regulations prescribe, and shall include in the return the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual.

This requirement is satisfied by the filing of a Form 1065 by the partnership (see sec. 1.6031-1(a)(1), Income Tax Regs.), but section 1.6031-1(d)(1), Income Tax Regs., stating a general exception, specifies that "A partnership carrying on no business in the United States and deriving no income from sources within the United States need not file a partnership return." However, with respect to such a foreign partnership that has a U.S. citizen or resident as one of its partners, the general exception from filing is modified by the provision that—

> Where a United States citizen or resident is a partner in a partnership described in subparagraph (1) of this paragraph which is not required to file a partnership return, the district director or director of the service center may require such person to render such statements or provide such

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[6] Sec. 743(b) specifically provides, in relevant part—

> In the case of a transfer of an interest in a partnership by sale or exchange or upon the death of a partner, a partnership with respect to which the election provided in section 754 is in effect shall—
>
> (1) increase the adjusted basis of the partnership property by the excess of the basis to the transferee partner of his interest in the partnership over his proportionate share of the adjusted basis of the partnership property, * * *

[7] The first taxable year of petitioner after the purchase of its partnership interest was the fiscal year ending June 30, 1974.

> information as is necessary to show whether or not such person is liable for tax or income derived from such partnership. *In addition, if an election in accordance with the provisions of section 703 (relating to elections affecting the computation of taxable income derived from a partnership) or section 761 * * * is to be made by or for the partnership, a return on Form 1065 shall be filed for such partnership.* * * * [sec. 1.6031-1(d)(2), Income Tax Reg.; emphasis added.]

To complete the delineation of the statutory and regulatory framework, we look to section 703(b) which provides—

> *Any election affecting the computation of taxable income derived from a partnership shall be made by the partnership*, except that any election under—
>
> (1) section 57(c) (defining net lease),
>
> (2) subsection (b)(5) or (d)(4) of section 108 relating to income from discharge of indebtedness),
>
> (3) section 163(d) (relating to limitation of interest on investment indebtedness),
>
> (4) section 617 (relating to deduction and recapture of certain mining exploration expenditures), or
>
> (5) section 901 (relating to taxes of foreign countries and possessions of the United States), shall be made by each partner separately.
>
> [Emphasis added.]

Petitioner's initial position is that no section 754 election statement was required to be filed. Its reasoning is as follows: (1) Section 754 specifically requires the statement to be filed with a U.S. partnership return; (2) under section 1.6031-1(d)(1), Income Tax Regs., the German partnership was not required to file a U.S. partnership return because it conducted no U.S. trade or business and had no U.S. source income; (3) moreover, the second sentence of section 1.6031-1(d)(2), Income Tax Regs., requiring a filing if an election under section 703 or 761 is to be made by or for the partnership, is inapplicable because section 703 is simply a catch-all provision directed solely toward those elections where the controlling statute is silent "as to the proper electing party" and thus does not cover the specific election set forth in section 754; and (4) therefore, absent any requirement to file a Form 1065 to which a statement of election must be attached, the German partnership could not make a valid election. Respondent counters with the assertions that: (1) Section 703 is not limited as petitioner contends and covers all elections relating to the computation of a partnership's taxable income including a section 754 election; (2) therefore the provisions of the second sentence of section 1.6031-1(d)(2), Income Tax Regs., are applicable; and (3) a U.S. partnership return with an attached statement of election was required to be filed for the partnership.

We acknowledge that a literal interpretation of section 703 may support petitioner's contention that the provisions of the second sentence of section 1.6031-1(d)(2), Income Tax Regs., do not apply to other statutory provisions which specify who is to make an election. For example, section 703 provides that the elections covered thereby are to be "made by the partnership," which would appear to be unnecessary as far as section 754 is concerned, which provides "if a partnership files an election." On the other hand, it can be argued that it is section 703 which provides that the election shall be made by the partnership, and section 754 simply provides for what happens if it does. Indeed, this view is confirmed by the action of the Congress in enacting section 404 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, 96 Stat. 324, 669, which presumably moots any future cases of the type involved herein. That section provides—

> Except as hereafter provided in regulations prescribed by the Secretary of the Treasury or his delegate, nothing in section 6031 of the Internal Revenue Code of 1954 shall be treated as excluding any partnership from the filing requirements of such section for any taxable year if the income tax liability under subtitle A of such Code of any United States person is determined in whole or in part by taking into account (directly or indirectly) partnership items of such partnership for such taxable year.[8]

Given the less than clear statutory and regulatory framework, we will assume for the purpose of decision herein that neither the German partnership nor petitioner on its behalf was to file a U.S. partnership return. However, contrary to petitioner's contention that the filing of a section 754 election is inextricably linked to the filing of a Form 1065, we find that while section 1.6031-1(d)(1), Income Tax Regs., relieves the German partnership of any obligation to file a U.S. partnership return, it does not follow that such relief extends to other types of action (such as a section 754 election) designed to confer a U.S. tax benefit. The legislative history of sections 754 and 743 reveals that when these provisions were enacted, Congress made it crystal clear that the partnership must file a statement of election. H. Rept. 1337, to accompany H.R. 8300, 83d Cong., 2d Sess. A232–233 (1954); S. Rept. 1622, to accompany H.R. 8300, 83d Cong., 2d Sess 406 (1954). To be sure, the legislative committees had in mind U.S. partnerships, but there is no indication that their concerns were so confined. Under the circumstances, we are not inclined to interpret whatever gap there may be in respondent's information return regulations so as to relieve a foreign partnership, or a U.S. partner acting on behalf of such a partnership, of the necessity of making an election with respect to the adjustment of basis pursuant to section 743(b). Therefore, we are still left with the question whether petitioner has established "that an election has been made, so that the [German partnership and its members] are bound." *Tipps v. Commissioner*, 74 T.C. 458, 468 (1980). We conclude that this question should be answered in the negative.

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[8] The reason given for enacting this provision was "The application of the partnership return filing requirements to certain foreign based partnerships with U.S. partners is unclear." H. Rept. 97-760 (Conf.) (1982), 1982-2 C.B. 600, 662.

We recognize that the German partnership had in fact made the adjustments to basis of the character contemplated by section 743. But, this action standing alone is not enough; an election must be filed under section 754. *Estate of Skaggs v. Commissioner*, 75 T.C. 191, 206 (1980), affd. per curiam 672 F.2d 756 (9th Cir. 1982). Indeed, petitioner, itself, obviously considered that something more than simply reporting its share of the German partnership loss for 1973 in its fiscal 1974 return was needed and decided to attach the partnership's German tax return. Petitioner's position is that the German tax return revealed sufficient information to put respondent on notice that an adjustment of the character envisaged by section 743(b) had been made and the clear inference to be drawn from the attachment of such return to petitioner's fiscal 1974 return is that it was an election which satisfied the requirements of section 754 and the regulations thereunder. We disagree.

We have examined the cases as to what constitutes a statement of election under various provisions of the Internal Revenue Code and have found that, absent a formal election, a submitted return and its attached schedules must evidence an affirmative intent on taxpayer's part to make the required election and be bound thereby. E.g., *American Air Filter Co. v. Commissioner*, 81 T.C. 709, 720–723 (1983); *Tipps v. Commissioner, supra* at 468–471; *Hewlett-Packard Co. v. Commissioner*, 67 T.C. 736, 747–750 (1977). Failure to manifest such intent has repeatedly resulted in taxpayer's alleged election being rejected. E.g., *Knight-Ridder Newspapers v. United States*, 743 F.2d 781, 793–797 (11th Cir. 1984); *Young v. Commissioner*, 83 T.C. 831, 839–840 (1984); *Estate of Skaggs v. Commissioner, supra* at 205–208; *Valdes v. Commissioner*, 60 T.C. 910, 913–915 (1973).

Applying these standards to the instant case, we find that the documents constituting petitioner's fiscal 1974 tax return do not make clear that a valid election was made to step up the basis of the German partnership's assets for U.S. tax purposes. To be sure, the parties have stipulated that the German partnership return "lists as the value of each of the German partnership's assets as of January 1, 1973, the amount by which petitioner's basis in its partnership interest in the German partnership immediately after its acquisition of such interest exceeded petitioner's allocable adjusted basis in each of the German partnership's assets." But, it is extremely difficult to extrapolate this date from the enclosure pertaining to petitioner. This is especially true in light of the fact that the enclosure (and the entire German tax return) is in German and that petitioner did not furnish respondent with a translation as part of its claimed election. The difficulty of extrapolation continues to exist, even after the English translation of the enclosure is examined. Concededly, the pertinent figures can be found in the enclosure, but their correlation is far from clear. The hard fact is that petitioner could easily have attached a statement (in English, of course) to its fiscal 1974 return, referring to the attached German partnership return, summarizing what was shown on the return with respect to the adjustments of basis, and affirmatively specifying that it was "electing" to make such adjustments, pursuant to section 754.[9] Such a statement might well, under the circumstances of this case, have been sufficient.

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[9] Due to its limited-partner status, petitioner lacked formal authority to make a binding election for U.S. tax purposes on behalf of the German partnership unless it obtained a power of attorney as called for in the partnership agreement. However, in light of the fact that the German

In the context of resolving the question of whether petitioner made a valid election, the fact that the issue of basis adjustment appears to have been easily discovered by respondent's agent, during the audit of the returns involved herein, is beside the point. "The Commissioner needs to know that an election has been made in order to determine whether an audit is necessary in the first place and what its scope should be." *Knight-Ridder Newspapers v. United States*, *supra* at 796. Cf. *Commissioner v. Lane-Wells Co.*, 321 U.S. 219, 223 (1944); *Pleasanton Gravel Co. v. Commissioner*, 64 T.C. 510, 526–527 (1975), affd. 578 F.2d 827 (9th Cir. 1978). The same is true with respect to petitioner's contention that respondent could have sought further information pursuant to the first sentence of section 1.6031–1(d)(2), Income Tax Regs. (p. 1079 *supra*).

We also reject petitioner's plea that its position in this case be sustained on the general principles of equity and fairness. Even if we were inclined to determine that petitioner was entitled to such equitable relief, we would be powerless to grant it, for as we have previously stated, this Court does not have equity jurisdiction. *Pesch v. Commissioner*, 78 T.C. 100, 130–131 (1982); *Lorain Avenue Clinic v. Commissioner*, 31 T.C. 141, 164 (1958).[10]

In sum, we conclude that petitioner, who has the burden of proof (Rule 142(a)), has failed to establish that the required election was made which would permit petitioner to have the benefit of the adjustments to basis pursuant to the provisions of sections 754 and 743. If the tables were turned, and respondent was contending over petitioner's objection that those adjustments should be made, petitioner could argue with impunity that the required election had not been made. See *Valdes v. Commissioner*, *supra* at 915.

In view of petitioner's concessions of all other issues,

Decision will be entered for the respondent.

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partnership had already stepped up the basis of the partnership's property pursuant to German law at the time petitioner's return was filed, and because Karl Mohring, the general partner of the German partnership, was also the president of petitioner, we doubt that petitioner would have had any difficulty in obtaining such authority. In so stating, we recognize that the German partnership may have been unwilling to authorize petitioner to file a U.S. partnership return (Form 1065) on its behalf (see sec. 1.6031–1(d)(2), Income Tax Regs.), although it appears that even this authority would not necessarily have been refused, since the German partnership was not subject to U.S. tax.

[10] See also *Doner v. Commissioner*, T.C. Memo. 1984–528.

PROCEEDINGS DISPOSED OF UPON MEMORANDUM OPINIONS

T.C. Memo.	*Name*
1985-460	Abbotts, Thomas E.
1985-402	Abramson, Edwin and Sondra
1985-402	Abramson, Jacob C., Estate and H. Cecelia
1985-392	Adair, William S. and Florence O., et al.
1985-597	Adelberg, Marvin and Helen M.
1985-581	Aderholt, Herbert and Helen
1985-491	Aderholt Specialty Co.
1985-581	Aderholt-Vient, Inc.
1985-630	Albert, Walter and Waltraut
1985-485	Albright, Robert B.
1985-500	Aldridge, Audrey Ann
1985-392	Alf, John J., and Marianne E.
1985-572	Aliamanu Homes, Ltd.
1985-329	Allen, James F.
1985-436	American Insulation Corp., et al.
1985-443	Ames, Henry B. and Dortha S.
1985-380	Andrews, Ira J., Jr., and Roberta D.
1985-559	Andrews, Jack G. and M. Georgette
1985-445	Apothaker, Benson
1985-504	Applegate, Edward A. and Charlotte M.
1985-484	Aronson, Karon S.
1985-469	Ates, Leroy D. and Mildred F.
1985-529	Austin National Bank, Independent Coexecutor
1985-456	Barnes, Eldred W. and Gloria
1985-397	Barnes, Gloria C.
1985-397	Barnes, Jonathan Richard
1985-581	Bartell, Lawson W. and Lavella J.
1985-362	Bates, Arthur N., III
1985-420	Baugher, James A. and Patricia A.
1985-378	Baxter, Albert Nathanial and Cleo Beatrice
1985-415	Baxter, Loren G. and Linda W.
1985-504	Bell, Daniel S.
1985-375	Bender, Daniel
1985-355	Bender, Gordon C.
1985-615	Benson, Robert T. and Linda C.
1985-630	Berman, William and Nana
1985-402	Bernhaut, Melvin S. and Judith I.
1985-612	Bliss, William L. and Mina D.
1985-429	Boggs, Geronimo V.
1985-421	Bolan, Arnold E. and Dean B.
1985-392	Borgeson, Donald R. and Cecile A.
1985-591	Botta, Samuel W. and Theresa E.

T.C. Memo.	*Name*
1985-501	Botwinick, Michael and Jane
1985-619	Boynton, Jay William
1985-500	Bracy, Calvin M. and Melinda M.
1985-466	Bradley, Joe E.
1985-364	Bradley, Margaret A.
1985-621	Bramlage, Judith L.
1985-481	Branson, Carl B.
1985-495	Brechtel, Ronald C. and Eve A.
1985-402	Breeden, Robert J. and Bessie N.
1985-572	Briggs Rental Co.
1985-321	Broome, William Hugh and Robin Dale, et al.
1985-564	Brown, Jack and Clara
1985-523	Burger, Thomas C. and Marian E.
1985-610	Buring, Sylvia S., Estate
1985-620	Burnett, Frank G. and Verna M.
1985-392	Burton, Hayward V. and Sandra G.
1985-583	Burwell, Clifton J. and Ginette A.
1985-613	Butler, Marvin J. and Joann J.
1985-318	Call, Thomas W. and Betty L.
1985-381	Calliham, Paul D.
1985-500	Campbell, William G. and Norma T.
1985-572	Cardiff Homes, Inc.
1985-360	Carter, J.A.
1985-352	Carver, Charles Lewis
1985-454	Carver, Robert W. and Diana
1985-530	Case, Horace S. and Peggy C.
1985-472	Casey, William M. and Liou Dien-Mei
1985-572	Central Development Corp.
1985-572	Champlin Corp.
1985-549	Chapin, Donald E., Personal Representative
1985-444	Chao, Wen Y. and Ching J.
1985-359	Chapman, Thomas O.
1985-572	Cielo Vista Corp.
1985-436	Cikutovich, Frank and Josephine
1985-505	Cillessen, Thomas C., Jr.
1985-367	Clemente, Inc.
1985-316	Cleveland Creative Arts Guild
1985-395	Clifton, James D. and Shirley
1985-392	Clow Corp.
1985-572	Cochita Pumice Co.
1985-336	Cockey, Patrick A.
1985-591	Cohen, Eileen and Estate of Harry
1985-591	Cohen, Harry, Estate and Eileen, as Executrix and Individually
1985-471	Cohen, Milton and Mildred
1985-480	Cohn, Arnold and Eleanor
1985-566	Colter Corp.
1985-430	Conlow, James W.
1985-486	Conn, Hershal R. and Betty G.
1985-513	Cornick, Lynn S.
1985-317	Costanza, Carl C. and Lena
1985-571	Costello, Edward J., Jr.
1985-464	Cox, Herbert L. and Johanna
1985-324	Cox, Walter B. and Virginia
1985-498	Crain, Thomas M. and Shelley L.
1985-402	Cramer, Gerald B. and Barbara
1985-392	Crawford, George W. and Betty L.
1985-533	Cristea, William B.

T.C. Memo.	*Name*
1985-553	Cruea, Gerald B. and Sharon S.
1985-376	Danville, Glass Co.
1985-356	Davis, Neil A.
1985-522	Davis, Yvette A.
1985-630	Dematoff, Seymour and Eleanor
1985-470	Derksen, Roy C.
1985-435	Devinaspre, Robert L.
1985-608	DiBernardo, Robert and Linda
1985-478	Dickey, Raymond L.
1985-611	Diercks, Kenneth W.
1985-361	Diffley, Michael
1985-551	Dorsey, Jane
1985-392	Drayton, Frank J., Jr., and Joyce E.
1985-630	Dunnett, Robert L. and Pamela J.
1985-455	Dye, Allen Kent
1985-353	Earp, Charles W. and Ruth T.
1985-327	Eggleston, Arlene, Transferee
1985-479	Ehlert, Delbert D.
1985-493	Elliott, Wayne Styron and Sandra Arlene
1985-511	Ellis, Betty Mayland
1985-401	Elshinnawy, Abdelfattah Mahmoud and Arlene Joan
1985-386	EMI Corp., an Illinois Corporation
1985-549	English, Homer O., Estate
1985-382	Epperson, Jessie Elvin
1985-326	Etter, R. Max, Jr., and Susan K.
1985-438	Eutsler, Gerald W.
1985-488	Farkas, Lee B.
1985-573	Farmers National Bank & Trust Co. of Ashtabula, Executor
1985-346	Farris, Harold
1985-518	Farrow, G.N. and Louise W.
1985-536	Faulkner, Patrick H. and Joyce A.
1985-569	Fedele, Robert D.
1985-351	Fern, Richard L. Karen A.
1985-345	Fields, Roscoe W.
1985-369	Figgie International, Inc. (Successor by Merger to Mid-Continent Manufacturing Co., Inc. and Subsidiaries)
1985-332	Financial Savings & Loan Association of Northern California, Successor-in-Interest to Redwood Empire Savings & Loan Association
1985-332	Financial Savings & Loan Association of Northern California (formerly Redwood Empire Savings & Loan Association)
1985-393	Flacco, Richard M. and Arlene
1985-602	Forster, Stanley A. and Dena
1985-572	Foster Development Corp.
1985-572	Foster Homes, Ltd.
1985-457	Fowler, Franklin S. and Jeanne C.
1985-451	Fox Park Corp.
1985-603	Franklin, Carey Allen
1985-542	Frick, C. Frederick and Patricia B.
1985-453	Friedman, Alvin G.
1985-474	Fulton Fish Distributors, Inc.
1985-423	Gable, Margaret B.
1985-363	Gallo, Mark S., Estate
1985-540	Gambardella, Vincent and Helen
1985-567	Gambrill, Charles A., Jr., John M., Monica C.,

T.C. Memo.	*Name*
	Peter R., Richard J., Stephen F.
1985-577	Garcia, Ralph G. and Karen J.
1985-630	Gardner, Maxine, et al., Trustees
1985-321	Garrett, John Lamar, Jr., and Kathleen De La Garza
1985-390	Gessler, Richard F.
1985-618	Gibson, William F.
1985-543	Giles, Morris A. and Marjorie P.
1985-394	Gillet, Charles B., Estate
1985-404	Gleeson, Michael F.
1985-628	Golden Pine Ranches, Inc.
1985-596	Goodsman, Gloria J.
1985-596	Goodsman, James R. and Marilyn E.
1985-502	Gookin, Jack M.
1985-411	Graham, Carl B. and Carmoleta F.
1985-608	Grama, Nathan and Francis
1985-560	Gregg, Philip Wallace
1985-367	Greggo & Ferrara, Inc.
1985-383	Haggerty, Robert J. and Bobbie M.
1985-357	Hamilton, Lewis V.
1985-440	Hanrahan, Homer E. and Roberta S.
1985-468	Harken, James H. and Joanne M.
1985-482	Hartman, Raymond M.
1985-525	Hedgebeth, Donald M.
1985-396	Herman, Max B. and Pearl
1985-557	Herman, Stanley I. and Linda
1985-414	Hobdy, Clarence C., Jr., and Margaret G.
1985-572	Highland Park Homes, Inc.
1985-461	Hodges, Irene McLaughlin and Thomas Lyman
1985-347	Hoerrner, August J.
1985-437	Hoffa, Randy Lee
1985-626	Holland, Brian
1985-627	Holland, Edward J., Jr.
1985-319	Horner, Thomas and Taria
1985-373	Hosbein, David J. and Florence T.
1985-497	Houlberg, Jens and Jane
1985-389	Houle, William H. and Laura C.
1985-408	Howe, Clarence K. and Margaret C.
1985-403	Hrdlicka, Larry J. and Frances
1985-348	Huey, Dicky and Neeta
1985-587	Hudgens, Robert O.
1985-628	Hudspeth, Fred E. and Margaret A., et al.
1985-628	Hudspeth, John R.
1985-628	Hudspeth, John and Floreine
1985-628	Hudspeth Pine, Inc.
1985-628	Hudspeth, Roger and Beverly
1985-628	Hudspeth, Ronald J. and Jane
1985-426	Humana, Inc. and Subsidiaries
1985-568	Huval, Louisa
1985-407	Inaba, Michael K.
1985-630	Jack Froom M.D. Medical Corp., a California Corporation
1985-628	Jackson, Gary N. and Anne E.
1985-609	Jacobs, Jerry C. and Isabel F.
1985-534	Johnson, Arthur Y.
1985-630	Johnson, Charles
1985-571	Johnsen, Manfredi & Thorpe, a Professional Corporation

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T.C. Memo.	*Name*
1985-516	Jones, Donna L. and Franklin J.
1985-402	Joseph, Frederick H. and Susan F.
1985-341	Kaji, Vikram H. and Andrea L.
1985-580	Kaster, Theodore G. and Nora L.
1985-402	Kay, David G.
1985-630	Kearns, Walter M. and Abigail
1985-599	Keeton, Roy and Shirley K.
1985-527	Kendel, Michael and Liddi
1985-604	Keppeler, Robert E. and Shirley A.
1985-400	Kern, Joan Marie
1985-508	Keys, Phyllis O.
1985-507	Keys, Robert L.
1985-500	Killough, Larry R. and Mary S.
1985-340	King, Jack B. and Paula H.
1985-550	Klein, Dennis Raymond
1985-610	Kornberg, Samuel, et al., Coexecutors
1985-496	Kravetz, Sydney C.
1985-410	Kurtz, James B. and Katherine C.
1985-410	Kurtz, W.C., Jr., and Almae Mae
1985-538	Labovitz, Elizabeth D., Estate
1985-630	LaFargue, Emily A.
1985-630	LaFargue, Esther, et al.
1985-630	LaFargue Trust
1985-337	Lagrone, David O.
1985-512	Lamb, Floyd R., et al.
1985-512	Lamb, Floyd R. and Eleanor S.
1985-512	Lamb, Floyd R. and Nancy
1985-431	Lamborn, George D.F. and Betty H.
1985-413	Landreth, Ivan K. and Lucille
1985-630	Langsam, Eugene H. and Myra C.
1985-385	Larvin, Andrew Joseph
1985-331	LaVerne, Richard
1985-372	Layden, John and Linda
1985-500	Leach, James R. and Carol S.
1985-384	Leong, Thomas and Gabriella K.
1985-365	Leonard, Dawn
1985-539	Lester, Gerald Thomas
1985-563	Lewis, Arnold L.
1985-370	Lichtenberger, James C.
1985-572	Likins-Foster Honolulu Corp.
1985-572	Likins-Foster Olathe Corp.
1985-572	Likins-Foster Salina Corp.
1985-572	Likins-Foster Topeka Corp.
1985-490	Lind, Norman P. and Phyllis M.
1985-595	Lindsey, William Hubert, Jr., Executor
1985-409	Lipson, Marvin and Rose C.
1985-427	Lockman, Lawrence E.
1985-552	Lombardo, Nunzio and Lucinda
1985-572	Lomita Homes, Inc.
1985-371	Long, Thomas
1985-326	Looney, Arlen B. and Doreen M.
1985-492	Lott, James Edwin
1985-526	Lovlien, David M.
1985-374	Lui, Percy T.W. and Marjorie
1985-342	Lund, Anthony J. and Junieve L.
1985-585	Lurkis, Jeffry L.
1985-328	Mabry, Ted L. and Marie E.

T.C. Memo.	*Name*
1985-428	Malek, Theresa M. and Edward J., Sr.
1985-452	Mallory, Kenneth B.
1985-467	Malnik, Alvin I. and Deborah C.
1985-565	Mannina, Pola
1985-554	Marian, Radu
1985-432	Marinovich, Mary Jane
1985-600	Marlin, Barry S.
1985-424	Martin, Roy O., Jr., and Barbara M.
1985-412	Marysville Development Co.
1985-398	Maynard, Monte E. and Dee B.
1985-392	McAllister, Thomas A. and Linda E.
1985-509	McCoy, Arthur H., Estate
1985-574	McKee, Charles Alexander and Mary Ann
1985-591	McKnight, Thomas L. and Ora T.
1985-567	Meers, James and Florence
1985-594	Mennella, Opal
1985-487	Metcalf, Alva W.
1985-605	Miller, Albert C.
1985-630	Misat Development Corp.
1985-573	Mitchell, Antoinette P., Estate
1985-629	Modern Security Life Insurance Co., Successor in Interest to Dynamic Security Life Insurance Co.
1985-365	Moore, Frank W. and Estate of Florence E.
1985-450	Mueller, Lester Walter
1985-326	Mullin, Ronald K. and Kathleen
1985-333	Myhrman, Ralph A. and R. Claire
1985-520	Neil, Garnett W. and Dorothy M.
1985-500	Nettles, James H. and Betsy M.
1985-591	Neuenschwander, Robert S. and Kathleen B.
1985-338	Nichols, Richard E. and Josephine
1985-535	Nilson, Frederick D.
1985-578	Nissho Iwai American Corp.
1985-391	Notter, George K. and Lorraine B.
1985-558	Notter, George K. and Lorraine B.
1985-347	O'Brien, Dennis R. and Julia
1985-616	O'Connor, George and Karla
1985-459	Odle, Felix and Aratha
1985-320	O'Hare, Linda S., formerly Linda S. McNeilly
1985-402	Osterstock, Roy E. and Doris H.
1985-586	Paddock, Richard W.
1985-591	Palestini, Dominick C.
1985-475	Palminteri, Charles
1985-475	Palminteri, Charles and Diane
1985-566	Palumbo, Joseph C. and Sandra C., et al.
1985-545	Parker, James J. and Rosemarie
1985-591	Peccole, William P. and Wanda
1985-524	Pechan, Bernard W., Estate
1985-418	Pendergraft, James D.
1985-590	Penny, James Leonard and Elaine Linda
1985-598	Perfetti, Angelo and Ramona E.
1985-581	Peters, Alfred G. and Marilyn G.
1985-422	Pitts, Marvin J.
1985-476	Piyiotis, Andreas and Ivy
1985-592	Platt, James B., III, and Victoria

T.C. Memo.	*Name*
1985-321	Pope, Bobby Lee and Elizabeth
1985-547	Powell, A.B. and Sue
1985-547	Powell, Opal M.
1985-577	Powers, Robert A. and Dianne E.
1985-463	Preston, Robert and Velda Lee
1985-562	Primoff, Bertram S.
1985-503	Proctor, Howard A.
1985-489	Pryor, Peter J. and Barbara J.
1985-402	Quittner, Herbert and Dorothy
1985-548	Ralph Sarcone, Inc., t/a Tekmatic
1985-617	Rector, Edmond C.
1985-332	Redwood Empire Savings & Loan Association, et al.
1985-630	Reiserer, Kenneth H. and Deanne E.
1985-433	Reiswig, Kurt W. and Lynne
1985-607	Reuter, Kenneth J. and Eleanor R.
1985-322	Rhoades Oil Co.
1985-555	Ripley, R. Bruce and Doris J.
1985-425	Roberts, David J. and Dolores C.
1985-419	Robinson, Arthur Lamar and Renita
1985-476	Rogers, Jannessa K.
1985-339	Rosebrough, James W. and Karen K.
1985-514	Rosenberg, Harry and Phyllis M.
1985-593	Rossum, Michael M. and Mary O.
1985-608	Rothstein, Theodore and Gladys
1985-406	Rubish, Argene J., Estate and Vivian M., Personal Representative and Surviving Wife
1985-368	Rutter, Ronald H. and Lyndia
1985-622	Sachs, Ralph G.
1985-436	Saluzzi, Canio and Joan
1985-561	Samuelson, Carl A., Jr.
1985-477	Sanderson, Walton W. and Beverly
1985-548	Sarcone, Ralph and Jean
1985-343	Saunier, Glenn R.
1985-604	Schlegal, Daniel and Joyce
1985-334	Schroeder, David L. and Tana
1985-556	Sell, Clegg Evander, Jr., and Donna Harris
1985-519	Seltzer, Mabel G., Estate
1985-465	Sensing, Randy K. and Carol
1985-442	Sentell, Elinor and Lional E., Sr.
1985-575	Shafer, Harvey E.
1985-402	Shapiro, Eli and Esther
1985-402	Sheid, Harvey L. and Rita, et al.
1985-529	Shepard, Margaret Jean Spillar, Independent Coexecutrix
1985-582	Shumaker, Emery Dale
1985-582	Shumaker, Mark Allen
1985-441	Siegel, David A. and Bettie I.
1985-515	Silverman, Harry T.
1985-334	Skyline Memorial Gardens, Inc.
1985-446	Smith, Donald E. and Alice B.
1985-366	Smith, Gene G.
1985-567	Smith, Harry J., Jr., and Norma D., et al.
1985-624	Smythe, James T. and Judith M.
1985-476	Snow, Maria
1985-354	Sowada, Michael
1985-463	Spade Operating Co.
1985-528	Spagnuolo, Joseph D. and Julie

T.C. Memo.	Name
1985-623	Spencer, Paul W. and Verna M.
1985-529	Spillar, Bliss R., Sr., Estate
1985-588	Spinks, Kenneth C.
1985-588	Spinks, Kenneth C. and Sharyn L.
1985-581	Stanislaus Housing Partners
1985-581	Steinert, Marvin E. and Adala N., et al.
1985-416	Steury, Virgil H. and Ada
1985-506	Stevens, B.J. and Ouida
1985-325	Stokes, William J.
1985-405	Stone, Myron I., Transferee (Supplemental Opinion)
1985-544	Stone, Shirold D. and Vivian C.
1985-532	Stoneking, Elenor Lorene
1985-439	Sullivan, Grant W.
1985-579	Sundin, Theodore A.
1985-521	Swan, Monroe
1985-388	Take, Thomas
1985-388	Take, Thomas and Janice
1985-448	Tarke, Louis and Betty
1985-449	Taylor, Harry Carl, II, and Karen (Edwards)
1985-323	Taylor, Hattie M. (Britt)
1985-499	Taylor, Samuel L. and Carol A.
1985-350	Terpil, Marillyn D. and Francis E.
1985-462	The Brook, Inc.
1985-614	The Brook, Inc. (Supplemental Opinion)
1985-628	Thomas, Andrew W. and Susan
1985-613	Timothy, James Arthur and Lawana
1985-572	T. Jack Foster & Sons, Inc.
1985-365	Tonasket, Leonard and Emma G., et al.
1985-402	Traynor, Alfred J. and Elizabeth L.
1985-358	Tucker, Carl Robert, III
1985-572	Turner & Associates, Ltd.
1985-335	Turnipseed, Bertha Jane
1985-335	Turnipseed, Pernelle Ray
1985-510	Tyler, James and Mabel
1985-399	Tyng, William Wark
1985-541	Valtsakis, Anna
1985-344	VanBibber, Virgil E. and Syble A.
1985-546	Van Cleve, Kenneth E. and Brunla A.
1985-581	Vient, Douglas C. and Darlene J.
1985-606	Wallace, Hugh J. and Minnie
1985-630	Walton, Verne M. and Patricia A.
1985-483	Ward, John Patrick
1985-601	Warda, Ethel
1985-392	Washington, Lester W. and Barbara
1985-570	Washington, Research Foundation
1985-589	Wasnick, Michael S.
1985-595	Watts, Martha B., Estate
1985-531	Watts, Richard A. and Laura M.
1985-473	Weaver, Duane M. and Priscilla P.
1985-604	Webster Tool & Die, Inc.
1985-417	Weeks, Ewell E. and Sara E.
1985-538	Weinman, Ruth, Executrix
1985-387	Weller, Delbert J. and Robina D.
1985-458	Wellford, Elizabeth R.
1985-349	Wernick, Richard F. and Beatrice
1985-625	Wham, Wayne Ernest
1985-377	White, Leo
1985-537	Whitman, Edward and Lillian
1985-500	Williams, Catherine

T.C. Memo.	*Name*
1985-476	Williams, Genelle, et al.
1985-330	Willis, Howell C. and Virginia L.
1985-581	Wizbowski, Raymond V. and Barbara
1985-500	Wofford, Jesse L. and Mary R., et al.
1985-494	Woo, Joseph S.H.
1985-494	Woo, Nancy N.C.Y.
1985-517	Wood, Robert, Estate, and Constance
1985-433	Wyman-Gordon Co. and Rome Industries, Inc.
1985-379	Yee, Shirley
1985-447	Yocum, Susan C. and Greg C.
1985-584	Yowell, James L.
1985-584	Yowell, James L. and Jean C.

INDEX-DIGEST

Page

ACCOUNTING METHODS
See **INVENTORIES**.

ADDITIONS TO TAX
See also **CONTRIBUTIONS, LOSSES, PENALTIES,** and **UNITED STATES TAX COURT**.

Negligence or Intentional Disregard of Rules or Regulations—Substantiation of Claimed Charitable Contributions—50% of Interest Payable Under Sec. 6601.—Court determined petitioners were liable (1) for 5% addition to tax under sec. 6653(a)(1) for negligence or intentional disregard of rules or regulations for 1979–81, since they failed to carry their burden of proof to show error on Commissioner's part, and record showed to contrary in that proffered alleged receipts were not admissible to substantiate claimed charitable contributions, and petitioners failed to comply with reg. 1.170A–1(a)(2) to disclose on their returns identity of charitable organization; and (2) for sec. 6653(a)(2) addition to tax equal to 50% of interest payable under sec. 6601 for 1981, since entire underpayment for each year was attributable to negligence as to claimed charitable contributions. ***Bell v. Commissioner*** 436

AMORTIZATION
See also **DEDUCTIONS**.

Income and Remainder Interests in Nondepreciable Assets—Acquired by Related Parties—Substance vs. Form.—Where petitioner H and petitioner W, latter as trustee of a trust established by H for the benefit of petitioners' children, entered into joint purchase agreements whereby, in form, H purchased income interests for life, and the trust purchased remainder interests, in certain bonds; and H entered into a similar agreement with himself as trustee of a pension trust for the benefit of his employees, Court determined that petitioners' amortization deductions for costs of income interests purportedly purchased by H were properly disallowed, since in substance H purchased bonds in their entirety and transferred remainder interests

AMORTIZATION—continued
to trusts, and in light of case law. H did no more than attempt to create amortization deductions by splitting nondepreciable assets. ***Gordon v. Commissioner*** 309

BASIS
See **CONSOLIDATED RETURNS** and **PARTNERSHIPS**.

CAPITAL EXPENDITURES

Legal Fees—Lawsuit To Compel Corporation To Disclose Information To Ascertain Stock Value for Sale Purpose—Capital Expenditure or Expense.—Where, for taxable years 1977 and 1978, petitioner sought to deduct under sec. 212(2) legal fees she incurred in litigation to compel closely held corporation in which she held stock to make financial information available to her, Court determined expenditures were not deductible but were to be capitalized and added to basis of stock, since petitioner's sworn statements and testimony clearly indicated origin of claim was to establish value of petitioner's stock for purpose of selling it. ***Neely v. Commissioner*** . 934

CAPITAL GAINS AND LOSSES
See also **DEDUCTIONS, INCOME**, and **NONRESIDENT ALIENS**.

Sham Gemstone Distributorship Franchise—Tax Shelter—Nondeductible Losses.—Where in 1979 petitioner, tax lawyer, purportedly purchased as tax shelter exclusive gemstone distributorship franchise for $384,000, Court determined on facts (1) program of exclusive territorial franchises was sham, was designed to avoid taxes by taking advantage of sec. 1253, and had no business purpose; (2) petitioner was not entitled to deductions for accrued distributor's fees under sec. 1253(d)(2)(B)(ii) or for deductions for interest on notes relating to exclusive territorial franchise; (3) petitioner was entitled to deduct under either sec. 212 or possibly sec. 162 ordinary and necessary expenses incurred in connection with certain distinct casual jewelry sales which, although wholly unrelated to his exclusive territorial franchise, were nevertheless profit oriented; and (4) burden of proof could not be shifted to Commissioner under sec. 183(d) for petitioner's not-for-profit activity, since his bona fide casual jewelry sales made outside his franchise territory could not be synthesized with his inactivity in his franchise to create illusion of a single "activity" under sec. 183 to support deduction of spurious exclusive "territorial distributorship fees." ***Moore v. Commissioner*** 72

Transfer of Appreciated Property to Former Spouse Under Divorce Decree—Division of Property or Taxable Event—State Law.—Where petitioner H transferred appreciated land to former W under 1978 property settlement agreement incident to divorce, Court determined under case law that transfer was nontaxable event,

CAPITAL GAINS AND LOSSES—continued
resembling more a division between co-owners than release of a legal obligation, since parties intended transfer to be division of property accumulated by their joint efforts during their marriage, and under Montana law, H and W at dissolution of marriage have a vested interest in property acquired during marriage regardless of which spouse holds title. ***McIntosh v. Commissioner*** 31

COMMISSIONER OF INTERNAL REVENUE
See **EXPENSES—TRADE OR BUSINESS, INCOME,** and **UNITED STATES TAX COURT**.

COMPENSATION
See **INCOME**.

CONSOLIDATED RETURNS

Net Operating Loss Carrybacks and Carryovers of Affiliated Group—Availability to Petitioner Where Consolidated Return Not Filed—Commissioner's Adjustment for Imputed Interest Income.—Where petitioner filed consolidated return in 1977–78 with its parent X and corporations Y and Z, consolidated return in 1976 with X and Y, and separate returns in 1975, Court determined (1) petitioner could not offset its 1975 taxable income with 1977–78 consolidated net operating losses attributable either to X, since reg. 1.1502–75(b)(3) was inapplicable and reg. 1.1502–79(a)(2) was unavailable because X had been inactive "shelf" corporation since July 15, 1974, or to Y, since subsidiary's portion of consolidated net operating loss can only be carried back to the separate return of the subsidiary's immediate parent corporation; (2) under limitation in reg. 1.1502–21(c)(2), Z's 1975 separate return loss could not be carried forward to reduce its 1977 separate taxable income computation and thereby increase the 1977 consolidated net operating loss for 1975; and (3) Commissioner could not impute interest income to petitioner under sec. 482, since in ultimate form and substance, funds transferred from petitioner to X were not loans but were corporate distributions. ***J. A. Tobin Construction Co. v. Commissioner*** 1005

Parent's Basis in Subsidiary Stock—Parent's Computation Consistent With Reg. 1.1502–32—Negative Adjustment Not Required by Reg. 1.1016–6(a).—Where petitioner corporation, in determining its gain on sale of all its stock in subsidiaries, computed its basis in subsidiary stock under reg. 1.1502–32, by reference to subsidiaries' earnings and profits reduced only by amount of straight-line depreciation, even though subsidiaries had used accelerated depreciation method; and Commissioner conceded that petitioner properly adjusted its basis in stock to reflect subsidiaries' earnings and profits, but argued that under reg. 1.1016–6(a), petitioner must further reduce its basis in stock for excess amount of accelerated over straight-

CONSOLIDATED RETURNS—continued

line depreciation to prevent petitioner from obtaining a "double deduction," Court determined that petitioner reached result mandated by Commissioner's consolidated return regs., which were legislative in character with force and effect of law and which had not been amended by Commissioner to reflect his changed position, and that reg. 1.1016–6(a) did not require a contrary result. ***Woods Investment Co. v. Commissioner*** 274

CONTRIBUTIONS

See also **ADDITIONS TO TAX, PENALTIES**, and **VALUATION**.

Charitable—African Art Objects—Valuation, Additions to Tax, Appraisal Expenses, and Interest on Substantial Underpayments Attributable to Tax Motivated Transactions.—Where petitioners made deductible charitable contributions of African art objects to qualified organizations, Court determined (1) Commissioner's valuations of donated art objects were sustained, since most of donated art was not traditional; (2) petitioners were liable for additions to tax under sec. 6653(a), since their actions in seeking another appraiser who could provide higher values pointed to intentional disregard of rules and regulations; (3) only $4,600 of $25,000 claimed as expenses relating to art appraisal fees required for determination of taxable income was deductible as such under sec. 212(3); and (4) amendment of Commissioner's answer to assert imposition of sec. 6621(d) interest rate on substantial underpayments attributable to tax-motivated transactions was not prejudicial to petitioners, since valuation overstatement was to be determined in aggregate and not on item-by-item basis. ***Neely v. Commissioner*** 934

Charitable—Lithographs Donated to Charitable Organizations—Valuation.—Where petitioners purchased substantial number of unframed, limited edition lithographs which they donated to qualified sec. 170(c) charitable organizations after holding them for period required for sec. 1222(3) long-term capital gain treatment, Court determined, for taxable years 1977 and 1979, fair market value of contributed lithographs did not exceed amounts that petitioners paid for them, since petitioners were ultimate consumers of the lithographs and market in which they purchased lithographs was appropriate market in which to value them for purposes of charitable contribution deduction. ***Lio v. Commissioner*** 56

Charitable for Conservation Purposes—Historic Building Facade—"Before and After" Valuation.—Where petitioners were limited partners in partnership which acquired and rehabilitated a building in the historic French Quarter of New Orleans and which granted to a qualified charitable organization an easement in perpetuity in facade of building; and grant qualified as "exclusively for conservation purposes" under sec. 170(f)(3)(B)(iii) and (C), Court determined fair market value of facade donation by applying "before

CONTRIBUTIONS—continued
and after" valuation approach utilized by expert witnesses of both parties, and by giving credit for post-donation renovations and by taking into consideration additional burden imposed on property by such easement, which resulted in 10% diminution in property's value. ***Hilborn v. Commissioner*** 677

COOPERATIVES

Farmers'—"Substantially All" Active Membership Requirement—Revocation of Exempt Status.—Where petitioners were tax-exempt farmers' cooperatives that sold supplies to, as well as marketed products of, their producer/members who held capital stock, and 84.78% and 82.52% of shareholders transacted business with the cooperatives during 1977 and 1978, Court sustained in this case Commissioner's use of 85% minimum threshold for the "substantially all" requirement of sec. 521(b)(2), approved in *West Central Cooperative v. U.S.*, 758 F.2d 1269 (8th Cir.), to revoke tax-exempt status of cooperatives. ***Farmers Cooperative Co. v. Commissioner*** 601

CORPORATIONS
See also **CAPITAL EXPENDITURES, CORPORATIONS, DIVIDENDS,** and **INCOME**.

Transfer to Controlled Corporation as Sec. 351 Exchange—Sec. 357 Applicability—H and W Both "Innocent Spouses" on Joint Return.—Where petitioner H transferred assets and business liabilities of his sole proprietorship to his pre-existing wholly owned corporation, and no additional stock or securities were issued, Court determined (1) requirements of sec. 351 were met in transfer of assets and liabilities to petitioner's wholly owned corporation, even though no additional stock was issued (*Abegg v. Commissioner*, 50 T.C. 145, overruled to extent inconsistent) so that sec. 357(c) was applicable; (2) liabilities assumed by corporation were in excess of adjusted basis of transferred assets, and under sec. 357(c) gain was recognized to extent of excess; and (3) sec. 6013(e) innocent spouse provisions were inapplicable, since omission of income resulted from misapprehension of tax laws, and Court perceived no inequity in holding both H and W to joint and separate liability. ***Lessinger v. Commissioner*** 824

CREDITS AND EXEMPTIONS
See also **DEDUCTIONS** and **ESTATE TAX**.

Investment Tax Credit—Cat and Dog Kennel as Single Purpose Agricultural or Horticultural Structure—Boarding Area as Inherently Permanent Structure.—Where petitioners claimed investment tax credits in 1976 for dog and cat kennel facility, part of which had been specially designed for temporary boarding and comfortable, sanitary maintenance of dogs, Court determined on facts, (1) kennel was not single purpose agricultural or horticultural

CREDITS AND EXEMPTIONS—continued

structure within meaning of secs. 48(a)(1)(D) and 48(p)(2), since temporary boarding of house pets did not constitute "housing, raising, and feeding a particular type of livestock" under sec. 48(p)(2); and (2) boarding area portion of kennel was not "tangible personal property" under sec. 48(a)(1)(A), since it was not "a structure which is essentially an item of machinery or equipment" under reg. 1.48–1(e)(1), and since it was inherently permanent structure under reg. 1.48–1(c). *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664, applied. ***McKenzie v. Commissioner*** 875

Investment Tax Credit—Horse Barn as Single Purpose Agricultural or Horticultural Structure—Validity of Reg. Excluding Horses From Livestock Definition.—Where petitioners claimed investment tax credits in 1976 for horse barn, which was general purpose "Lester" building, design of which petitioners varied for their Arabian horse breeding and showing activities, Court determined (1) on facts, horse barn was not single purpose agricultural and horticultural structure under secs. 48(a)(1)(D) and 48(p), qualifying as sec. 38 property, since it was not specifically designed and constructed for "housing, raising, and feeding a particular type of livestock" within meaning of sec. 48(p)(2); and (2) reg. 1.48–10(b)(3), which excludes horses from definition of livestock for sec. 48(p)(2), was valid. ***McKenzie v. Commissioner*** 875

Investment Tax Credit—Noncorporate Lessor—No Trade or Business Test in Sec. 46(e)(3)(B).—Where in 1979 petitioner general partners purchased a crane with recourse financing obtained from unrelated creditor; partnership entered into short-term lease of crane to petitioner's closely held corporation at fair rental value; and partnership incurred ordinary and necessary expenses for maintenance and repair of crane during first 12 months of lease term that exceeded 15 percent of lease payments received from lessee, Court determined petitioners as noncorporate lessors were entitled to investment tax credits for crane, since there is no trade or business test in sec. 46(e)(3)(B) beyond the two objective tests therein, but even so, petitioners would satisfy such test. ***Miller v. Commissioner*** 1064

Investment Tax Credit—Previously Exhibited and Modified Films—Amount of Credit for Qualified Films.—Where in 1977 and 1978 petitioner corporation was in business of renting films to general public, Court determined, for purposes of claimed investment tax credit under sec. 48(k), that (1) films petitioner acquired that might have been previously exhibited in Mexico did not constitute "new sec. 38 property" (***Fife v. Commissioner***, 82 T.C. 1, followed); (2) previously exhibited film segments, spliced together and compiled and distributed as packages by petitioner, were insufficiently modified to create "reconstructed films" constituting new sec. 38 property; (3) petitioner's 30-minute edited film of Spanish bullfights and several previously unreleased films of live Beatles concerts were "qualified films" under

Page

CREDITS AND EXEMPTIONS—continued
sec. 48(k)(1)(B), since they were not "primarily topical" or "essentially transitory in nature"; and (4) petitioner could claim only two-thirds of its claimed credit because it failed to make proper election under sec. 48(k)(3). ***Budget Films, Inc. v. Commissioner*** 114

DAMAGES
See **LOSSES**.

DEDUCTIONS
See also **PARTNERSHIPS**.

Cattle-Feeding Investment as Tax Shelter—Tax Losses and Prepaid Cattle-Feed Expense—Bona Fides and Step Transaction Doctrine.—Where cash-basis petitioners H and W invested in cattle-feeding program in December 1971 through corporation X, a subchapter S corporation of which W was sole shareholder; petitioners funded investment in part with proceeds of bank recourse loan that was secured by certificate of deposit purchased by feed yard; X prepaid and deducted feed expenses in 1971, although none of feed was consumed in 1971; in February 1972, petitioners formed partnership A that purchased all stock of X through sec. 453 installment sale, X was liquidated, and A claimed stepped-up basis in assets received from X, including fully expensed feed, Court determined, on evidence, (1) petitioners' cattle-feeding operation was not sham, but step-transaction doctrine was applied to recast transaction to disregard X, which served no business purpose other than to achieve tax advantages; (2) petitioners were entitled to deduct in 1971 cattle-feed expenditure paid, since expenditure was a payment and not a deposit, tax avoidance was not primary purpose of prepayment, and there was no material distortion of income under reg. 1.461-1(a)(1), considering special treatment traditionally granted farmers under regs.; and (3) H is not entitled to sec. 172 net operating loss deduction in 1973 as his distributive share of alleged theft of partnership funds by W, absent any evidence funds were used for other than partnership purpose. ***Packard v. Commissioner*** 397

Depreciation and Investment Tax Credit—Publication of Book—Requisite Profit Motive.—Where petitioner purchased rights to book, giving nonrecourse promissory note as part of purchase price, and arranged for independent parties to publish and distribute the book, Court denied petitioner's claimed depreciation deductions and investment tax credit, since on record, petitioner's activity with respect to book did not constitute an activity engaged in for profit. ***Beck v. Commissioner*** 557

Losses From Distributorship Investment—Not-for-Profit Activity—Claimed Business Expenses, Interest, Depreciation, and Amortization.—Where petitioners claimed losses in 1978 and 1979 resulting from investment in a distributorship of a product which was

Page

DEDUCTIONS—continued

never manufactured, Court determined petitioners were not entitled to deduct (1) any part of recourse and nonrecourse notes delivered in payment for annual use fees of the distributorship under secs. 162(a) and 1253(d)(1), since petitioners failed to establish requisite profit motive; (2) interest with respect to acquisition fee under secs. 183 and 163(a), since purchase price was excessive, liabilities were contingent and unenforceable, manufacturing and marketing of the product were impracticable, and no profits were ever generated; (3) amounts for depreciation and amortization of acquisition fee under sec. 1253(d)(2)(A), since considering statutory language and legislative history, active trade or business was required for deduction; and (4) any of claimed deductions under sec. 183(b)(2), since no gross income was generated by the activity. ***Herrick v. Commissioner*** 237

DEFICIENCY NOTICE
See **LIMITATIONS**.

DEPRECIATION
See also **DEDUCTIONS**.

Railroad Boxcars—Half-Year or Averaging Convention—Substantial Distortion of Depreciation Allowance.—Where petitioners computed depreciation deductions on railroad boxcars acquired and placed into service Oct. 31 and Nov. 1, 1979, using half-year or averaging convention which resulted in 6 months' depreciation allowance for 1979, Court determined petitioners were not entitled under sec. 167(a) and (m) to use half-year or averaging convention, but were limited to 2 months' depreciation when boxcars were used, since petitioners failed to make valid class life asset depreciation range system election under reg. 1.167(a)–11, and use of multiple asset account convention substantially distorted depreciation allowance within meaning of reg. 1.167(a)–10(b). ***Fuentes v. Commissioner*** 657

DIVIDENDS

Constructive—Petitioners' Expenses Paid by Wholly Owned Corporation—Ninth Circuit Test.—Where petitioners' wholly owned corporation paid certain amounts relating to auto, boat, travel, insurance, and other unidentified expenses for the benefit of petitioners, Court applied constructive dividend two-part test of 9th Circuit, to which appeal would lie, that expenses must be nondeductible to corporation and also represent some economic gain or benefit to shareholder, and determined (1) on facts and circumstances, 75% of Blazer vehicle expenses were for legitimate business purposes and did not constitute constructive dividends; (2) corporate expenditures for travel and boat expenses were constructive dividends, since petitioners failed to meet any of substantiation requirements of sec. 274(d) and expenditures were for personal benefit of petitioner; (3) life insurance

DIVIDENDS—continued

premiums were constructive dividends, absent any evidence that premiums were not for their personal benefit; and (4) unidentified expenses were constructive dividends, since petitioners failed to establish that amounts paid had any business purpose or that payments were not for their benefit. ***Falsetti v. Commissioner*** 332

EMPLOYEES' TRUSTS

Lump-Sum Distribution From Profit-Sharing and Pension Plans—Separation From Service Requirement—Change in Employment Status From Employee to Independent Contractor.—Where petitioner physician as of July 1, 1979, terminated his employment agreement with medical clinic, sold his stock, and divested himself of all his economic interests with clinic, but on July 2, under association agreement, entered into independent contractor relationship with clinic and continued to provide the same services as a physician; and upon terminating his employee relationship, petitioner received a distribution from clinic's qualified profit-sharing and pension plans, Court determined petitioner was not entitled to use 10-year averaging method provided by sec. 402(e)(1) in reporting distribution, since his change in employment status from employee to independent contractor was not "separation from the service" within meaning of sec. 402(e)(4)(A)(iii) in that he did not sever his connection with clinic and distribution was not "lump-sum distribution" as defined in sec. 402(e)(4)(A). ***Reinhardt v. Commissioner*** 511

ESTATE TAX

Credit for Foreign Death Tax—Qualification of Canadian Tax—U.S.-Canada Estate Tax Convention.—Where petitioner estate paid tax to Canada on Canadian property owned by decedent when he died in 1980; Canadian tax assessment was computed on difference between value of property on date of death and value of property on Jan. 1, 1972, date relevant provisions of Canada Income Tax became effective; and Commissioner, after issuing deficiency notice, allowed deduction under sec. 2053 for Canadian tax paid, resulting in no deficiency, Court determined, on remaining issue of petitioner's claimed overpayment of tax, (1) Canadian tax did not qualify as substantial equivalent of estate tax for sec. 2014 credit, since focus of relevant Canadian statute was on recognition of gain or loss, not on taxation of transmission of property from dead to living, and (2) Canadian tax in question was not covered by U.S.-Canada Estate Tax Convention, Feb. 17, 1961, 13 U.S.T. 382, T.I.A.S. No. 4995, since only similarity between income tax at issue and tax eligible for credit under Convention was that both taxes might arise upon death of taxpayer. ***Estate of Ballard v. Commissioner*** 300

Interest as Part of "Overpayment" Under Sec. 6512(b)—Paid on Sec. 6166A Estate Tax Installment Payments Before Determination of Overpayment—Tax Court Jurisdiction To Review

Page

ESTATE TAX—continued

Amount of Interest.—Where petitioner estate paid estate tax and interest thereon in installments under sec. 6166A; and after Commissioner determined deficiency and petitioner filed petition, parties agreed that there was no deficiency and that petitioner had in fact overpaid its estate tax, Court determined (1) under sec. 6512(b), Tax Court has jurisdiction to determine an overpayment of interest as part of its jurisdiction to determine an overpayment of tax on which the interest was paid, considering statutory language and framework, regs., case law, and fact that it would be unjust to bifurcate "overpayment" by limiting a taxpayer's refund to "tax" only, and (2) Commissioner's original allocations of sec. 6616A installment payments between principal and interest were proper. *Capital Building & Loan Association v. Commissioner*, 23 B.T.A. 848, and *Steubenville Bridge Co. v. Commissioner*, 11 T.C. 789, overruled to extent that they are inconsistent. ***Estate of Baumgardner v. Commissioner*** 445

ESTATES AND TRUSTS

See also **EXPENSES—TRADE OR BUSINESS, GIFTS**, and **TRANSFEREES**.

Gross Estate—Marital Deduction—Liability of Estate or Beneficiary for Estate Tax on Nonprobate Life Insurance Proceeds.—Where decedent's gross estate consisted of nonprobate assets, including life insurance payable to decedent's son, and probate assets; will of decedent, who died Jan. 15, 1979, provided that estate and inheritance taxes were to be paid out of general estate, and expressly included tax attributable to nonprobate assets; decedent's son, who was sole beneficiary under will, disclaimed his testate and intestate interests; and net probate estate consequently passed by intestacy to decedent's surviving spouse and qualified for marital deduction, Court determined, (1) petitioner estate was liable for payment of estate tax attributable to life insurance, since decedent's tax clause precluded executor's right to require reimbursement from beneficiary under sec. 2206; (2) net probate estate and allowable marital deduction under sec. 2056 were reduced because estate tax attributable to life insurance proceeds was liability of estate; and (3) net probate estate and marital deduction were also reduced by amount of State inheritance tax imposed upon property that passed to surviving spouse. ***Estate of Boyd v. Commissioner*** 1056

EVIDENCE

Drug Enforcement Administration Reports—Information Supplied by Informant—Inadmissible as Hearsay.—Where in 1977 petitioner earned income from the sale of metamphetamine, a controlled substance, and Commissioner based his determination of petitioner's income tax deficiencies upon information supplied by Government informant to Drug Enforcement Administration (DEA),

Page

EVIDENCE—continued

Court determined (1) deficiency notice was not arbitrarily issued, since there was sufficient substantive evidence linking petitioner to tax-generating activity, (2) DEA reports were inadmissible as evidence, since they were hearsay declarations and did not fall under the business record or public record exceptions because they lacked trustworthiness; and (3) on evidence, amount of income earned was $254,240. ***Shriver v. Commissioner*** 1

EXEMPT ORGANIZATIONS
See also **COOPERATIVES**.

Charitable Fund Solicitor—Retroactive Revocation of Exempt Status—Burden of Proof as to Character of Donee Schools and Effective Date of Revocation.—Where petitioner organization that solicited funds for distribution to private schools obtained exempt status under sec. 501(c) in 1961 which respondent revoked in 1978 retroactive to 1974, sought declaratory judgement under sec. 7428 after its motion for summary judgment was denied, Court determined (1) petitioner had burden of proving that donee schools had adopted nondiscriminatory policies, and he failed to bring forth any evidence on this issue; and (2) Commissioner did not abuse his discretion under sec. 7805(b) in making the revocation retroactive to 1974, since petitioner received written notice in 1972 that its exempt status might be revoked. ***Virginia Education Fund v. Commissioner*** 743

Religious—Qualification as—Substantial Nonexempt Purpose and Private Inurement.—Where petitioner was formed in part to conduct religious services, promote doctrine of Triune of Life, perform sacrament of "spinology," train "spinologists," and maintain and operate spinal tutoriums; and practice of spinology was similar to practice of chiropractic in that spinal manipulation is performed for fees in both instances, Court determined in sec. 7428 declaratory judgment action that petitioner did not qualify for tax-exempt status under sec. 501(c)(3), since petitioner failed to carry its burden of proving it was operated exclusively for exempt purposes and that no part of its net earnings inured to the benefit of any private individual. ***Triune of Life Church, Inc. v. Commissioner*** 45

Religious—Unrelated Trade or Business—Exception for Farm Work Performed Without Compensation.—Where petitioner was Indiana nonprofit corporation exempt from taxation under sec. 501(c)(3) as member of U.S. Catholic Conference; in 1955 petitioner was given to Southwest Province of Holy Cross Brothers to provide it with source of income; and Brothers provided 91% of full-time labor and 94% of total hours worked in operation of petitioner's 1600-acre commercial farm, Court determined on facts that under sec. 513 for taxable years 1977–79, petitioner's farming operation constituted trade or business that was not substantially related to its exempt purpose, but its farming activity fell within sec. 513(a)(1) exception to

EXEMPT ORGANIZATIONS—continued
definition of unrelated trade or business, since substantially all of its farm work was performed by its members without compensation. ***St. Joseph Farms of Indiana Brothers of Congregation of Holy Cross, Southwest Province, Inc. v. Commissioner*** 9

EXPENSES—NONBUSINESS
See **LOSSES**.

EXPENSES—TRADE OR BUSINESS
See also **CAPITAL EXPENDITUES, DEDUCTIONS, DIVIDENDS,** and **INCOME**.

Entertainment—Substantiation Requirements—Union Representative.—Where petitioner was employed as a union representative in 1982, and claimed employee business expenses which were in part substantiated by a diary maintained by petitioner and in part unsubstantiated, Court sustained Commissioner's disallowance of certain items for lack of substantiation, but allowed in full expenditures substantiated by diary, to which were stapled receipt stubs from bars or restaurants showing date and amount of charge and which contained notations showing persons entertained, which satisfied requirements of reg. 1.274–5(b). ***Bell v. Commissioner*** 436

Fines Against Truck Driver, Fines Against His Employer Withheld From His Salary, Travel Expenses, Etc.—Sec. 162(f) Applicability—Tax Home.—Where in 1981 petitioner, owner-operator of tractor, pulled tractor trailers for a single carrier, spent 227 days on the road and 138 days at his parents' home, and paid his mother $503 for use of bedroom and bathroom for year, Court determined (1) on facts, petitioner was not entitled to deduct any claimed travel expenses under sec. 162, since he had no tax home; (2) petitioner was not entitled to deduct any fines resulting from his operation of his truck, which were nondeductible expenses under sec. 162(f); (3) petitioner was entitled to deduct under sec. 162(a) as trade or business, amount withheld from his paycheck by employer to pay a fine for violation charged against the employer for issuing petitioner inadequate lease, since language of sec. 162(f) does not render nondeductible such payments made to his employer through withholding from his pay; (4) petitioner was entitled to deduct cost of mattress and sheets used in his truck; and (5) tennis shoes worn exclusively in petitioner's work were nondeductible, since they were not specifically required as a condition of employment and could be used as ordinary clothing. ***Barone v. Commissioner*** 462

Professional Corporation's Contributions to Trust for Malpractice Protection—Deductibility—Trust Income Taxable to Corporation Under Grantor Trust Rules.—Where petitioner professional medical corporation of anesthesiologists established petitioner trust to provide protection from malpractice claims resulting from

EXPENSES—TRADE OR BUSINESS—continued

acts of petitioner's employees, Court determined (1) corporation was not entitled to deduct contributions to such trust as insurance expense, since risk of loss did not shift from corporation to trust; or as payments to employee benefit plan, or as ordinary and necessary business expense, and (2) interest income generated by trust funds was taxable to corporation, since trust was not a voluntary employees' beneficiary association under sec. 501(c), an insurance company, or an association for tax purposes under sec. 7701(a)(3), but was a grantor trust, since trustee was nonadverse party, and trust funds could be used to satisfy corporation's legal obligation on malpractice claims resulting from acts of its employees. ***Anesthesia Service Medical Group, Inc. v. Commissioner*** 1031

Travel, Automobile, and Entertainment—Travel Agency Activities—Separate and Independent Business of Petitioners or Business of Wholly Owned Corporation.—Where petitioners H (airline pilot) and W (school teacher) incurred unreimbursed travel, automobile, entertainment, and away-from-home travel expenses in connection with activities involving their wholly owned travel agency from which they received no income, Court determined on facts that expenses were not deductible by petitioners as ordinary and necessary, or educational, expenses, or as unreimbursed employee business expenses, since petitioners were not in trade or business of being independent commissioned travel agents, and expenses they incurred were for benefit of travel agency. **Leamy v. Commissioner** 798

Veteran's Reimbursed Flight-Training Expenses—Commissioner's Retroactive Application of Rev. Rul. 80–173—Distinction Between Two Types of Educational Assistance Not Abuse of Discretion.—On remand of T.C. Memo. 1983–94 from 3d Circuit Court of Appeals (751 F.2d 146) to decide issue of whether Commissioner abused discretion in applying Rev. Rul. 80–173 retroactively to petitioner Air Force veteran in violation of his right to equal treatment in application of the tax laws, and to consider effect of Rev. Rul. 83–3, issued after *Manocchio* and applied prospectively, Court determined that Commissioner's retroactive application of Rev. Rul. 80–173 did not make impermissible distinction between two types of treatment for educational assistance payments, since difference in computation showed that Commissioner's distinction was not devoid of rational basis. *Manocchio v. Commissioner*, 78 T.C. 989, affd. 710 F.2d 1400 (9th Cir.), followed. **Becker v. Commissioner** 291

FOREIGN CORPORATIONS
See **UNITED STATES TAX COURT.**

GAIN OR LOSS

Nonrecognition—Exchange of Insurance Policies—Surrender of Annuity Contract and Immediate Reinvestment in Compara-

Page

GAIN OR LOSS—continued

ble Contract With Different Company.—Where in 1980 petitioner surrendered an annuity policy with company X and immediately reinvested proceeds in comparable annuity with company Y, and there were no restrictions on use of proceeds petitioner received from company X, Court determined transaction was nontaxable exchange within meaning of sec. 1035, considering congressional intendment, clear terms of sec. 1035, and applicable regulations. ***Greene v. Commissioner*** 1024

GIFT TAX

See **GIFTS.**

GIFTS

See also **INCOME.**

Valuation of Paintings Transferred to Trusts—Number of Gifts and Applicability of Blockage Discount—Qualification for Annual Exclusions From Gift Tax.—Where on Dec. 21, 1976, petitioner transferred 1,226 gouaches to four trusts, involving six beneficiaries, Court determined on facts for gift tax and valuation purposes (1) there were six separate gifts, and not four as petitioner contended, considering case law and terms of trust instruments; (2) blockage discount was appropriate, but was to be applied to each gift separately and not on aggregate basis, and was to be based on actual annual sales for each gift; and (3) petitioner was not entitled to $3,000 annual exclusions under sec. 2503(b) for each of gifts, since gifts did not create present interests, absent showing that trust assets would generate income for distribution to beneficiaries. ***Calder v. Commissioner*** 713

INCOME

See also **AMORTIZATION, CONSOLIDATED RETURNS, EXPENSES—TRADE OR BUSINESS,** and **NONRESIDENT ALIENS.**

Commissioner's Allocation—Purchase Discounts Given to Corporate Subsidiary—Applicability of Resale Price Method.—Where in 1975–77 petitioner corporation X granted its wholly owned subsidiary Y purchase discount of 10% on sales of truck units and truck parts, which Y resold in foreign markets, and effect of discount was to increase Y's income, resulting in greater DISC deferral and reduced taxes paid by X and its subsidiaries on consolidated returns, Court determined Commissioner was not arbitrary in adjusting sales prices under sec. 482 on truck units; and on facts, amount of adjustment on truck units was to be computed by resale price method, since there were no comparable uncontrolled sales prices due to difference in geographic markets in which Y sold as wholesaler, whereas X's divisions sold directly to domestic dealers; but sales price

INCOME—continued

on parts needed no adjustments since it was comparable to arm's-length price. ***Paccar, Inc. v. Commissioner*** 754

Commissioner's Allocation—Royalties Paid by Domestic Subsidiary to Foreign Parent—Value of Services Performed for Another Member of Controlled Group.—Where petitioner, wholly owned U.S. subsidiary of its Swiss parent, paid 10% royalty on its net sales in exchange for exclusive license to manufacture, formulate, and sell certain triazine herbicides in United States, Court determined, on facts, (1) Commissioner abused his discretion under sec. 482 when he reduced petitioner's royalty rate to 6%, since 10% constituted arm's-length consideration for licenses under factors identified in reg. 1.482-2(d) 2(iii), but petitioner was not entitled to additional setoff for royalties in excess of 10%; and (2) under reg. 1.482-2(b), $100,000 was properly allocable to licenses over respective terms thereof, as setoffs against royalty payments, for petitioner's services towards development of licensed triazine herbicides. ***Ciba-Geigy Corp. v. Commissioner*** 172

Exclusions—Lodging Furnished by Employer to Resident Watchmen in Forest Preserve—Deductibility of Residence Utility Costs as Business Expense.—Where lodging was provided rent-free by employer to petitioners who were employed as resident watchmen in forest preserves to protect against fire, vandalism, and encroachment, Court determined (1) fair market value of lodging was excludable from petitioners' gross income under sec. 119, since lodging was furnished for convenience of employer, was located on employer's land and was integrally related to employer's business activity, and petitioners were required to accept lodging as condition to employment; but (2) utility expenses for residence were not deductible under sec. 162, absent any basis upon which an allocation of utility expenses between business and personal use could be made. ***Vanicek v. Commissioner*** 731

Exemption From Tax Under Panama Canal Treaty—U.S. Air Force Employee—Interpretation of Ambiguous Term.—Where petitioner, U.S. Air Force employee residing in Panama, claimed total exemption from U.S. income taxes in 1980 under art. XVI of the Agreement in Implementation of Article IV of the Panama Canal Treaty of 1977 which states that members of the Forces "shall be exempt from any taxes," Court determined that treaty did not exempt petitioners from U.S. income taxes, since treaty language, in light of legislative history and diplomatic correspondence, refers to Panamanian taxes only. ***Rust v. Commissioner*** 284

Financial Institution—Premature Withdrawal Penalties—Not Income From Discharge of Indebtedness Under Secs. 108 and 1017.—Where petitioner savings and loan institution was entitled to receive penalties from depositors because of premature withdrawals from their accounts; petitioner generally credited depositors' accounts

Page

INCOME—continued
with compound interest on daily basis; and depositors were entitled to withdraw interest but incurred penalty if principal was withdrawn before maturity of certificate, Court determined that penalty for premature withdrawal did not give rise to income from discharge of indebtedness within meaning of secs. 108 and 1017, since on facts and under case law and legislative history, forfeiture was separate and distinct obligation required of depositors for early withdrawal and not a forgiveness or discharge of the debt. ***Colonial Savings Association v. Commissioner*** 855

In Respect of Decedent—Surviving Spouse's Sec. 691(c) Income Tax Deduction—Availability of Marital Deduction in Recomputation of Estate Tax.—Where decedent included in his will formula maximum marital deduction bequest; in 1976–77, his surviving spouse received certain payments which constituted income in respect of a decedent (IRD) as part of her marital share and which were includable in her gross income under sec. 691(a); and necessary step in computing amount of sec. 691(c) income tax deduction for estate tax attributable to IRD is recomputation of estate tax without including IRD, Court sustained petitioner's contention that full maximum marital deduction, subject only to 50-percent limitation of sec. 2056, was allowable in recomputation of estate tax. ***Estate of Kincaid v. Commissioner*** .. 25

Office Furniture Transferred to Corporate Officer—Gift or Compensation.—Where petitioner H was president, chairman of the board, and chief executive officer of corporation X that was merged into corporation Y in 1975; in 1976, H became consultant to Y under option in his employment contract; and in same year, when X's offices in Oklahoma City were closed, and its operations were transferred to Y's Chicago headquarters, office furniture with book value of $11,856 that H had used in Oklahoma City was transferred to him, Court sustained Commissioner's determination that transfer was not gift, that fair market value of furniture was $11,856, and that petitioners' taxable income for 1976 should be increased by that amount, since petitioners' evidence of "gift" was unpersuasive, and petitioners offered no evidence of value. ***Neely v. Commissioner*** 934

Payment Terminating Stock Option—Capital or Income—Consulting Fee Taxable to Whom.—Where petitioner received from employer payment in exchange for termination of stock option acquired pursuant to employment agreement and fee for consulting services performed by petitioner which his wholly owned corporation reported as income, Court determined (1) amount received in exchange for termination of option was compensation to petitioner under sec. 83, since option was not transferable and not immediately exercisable in full and did not have a readily ascertainable fair market value, (2) consulting fee was taxable to petitioner, since he failed to prove that he was employee of his corporation or that his performance

INCOME—continued
of consulting services was controlled by his corporation. ***Bagley* v. *Commissioner*** 663

INDIVIDUAL RETIREMENT ACCOUNTS

Annuity Contract—Effect of Borrowing On—Disqualification.—Where on July 1, 1980, petitioner H borrowed against his individual retirement annuity; at time of borrowing, annuity qualified as individual retirement annuity as defined in sec. 408(b) and petitioner repaid loan in full prior to Apr. 15, 1981, Court determined petitioners were required to include in their gross income for 1980 fair market value of annuity contract as of Jan. 1, 1980, since not withstanding misinformation given by their insurer's representative, H's borrowing was a borrowing under or by use of an individual retirement annuity, and under sec. 408(e)(3), annuity ceased to qualify as an individual retirement annuity as of Jan. 1, 1980. ***Griswold* v. *Commissioner*** 869

INDIVIDUAL RETIREMENT PLANS

Contribution to Individual Retirement Account—Deductibility—Active Participation in Employer's Qualified Pension Plan in Same Year.—Where petitioner participated in employer's qualified retirement plan during 3 months of employment in 1981 and, upon termination of employment, irrevocably forfeited all rights in plan; and subsequently, in 1981, petitioner contributed $1500 to Individual Retirement Account and deducted that amount on his income tax return, Court determined (1) IRA contribution was not deductible under sec. 219(b)(2)(A)(i), since petitioner was "active participant" in qualified pension plan in 1981 (*Hildebrand v. Commissioner*, 683 F.2d 57 (3d Cir.), followed); and (2) entire contribution represented excess contribution subject to excise tax under sec. 4973. ***Eanes* v. *Commissioner*** 168

INTEREST
See **CONSOLIDATED RETURNS, CONTRIBUTIONS,** and **DEDUCTIONS.**

Rate on Substantial Underpayments of Tax Attributable to Tax Motivated Transactions—Constitutionality of Sec. 6621(d) as Applied—Damages Not Imposed as Penalty.—Where petitioners timely filed their 1978 income tax return; based on his finding that petitioners had a substantial underpayment attributable to a tax motivated transaction under sec. 6621(d)(3)(A)(1) for 1978, Commissioner sought application of increased rate of interest under sec. 6621(d) with respect to interest which accrued after Dec. 31, 1984 (effective date of that section); and petitioners conceded entire amount of deficiency, Court determined (1) application of sec. 6621(d) to interest which accrued after effective date of that section on petitioners' underpayment of their 1978 tax liability was not unconstitutional

Page

INTEREST—continued
and did not constitute retroactive application of sec. 6621(d); and (2) on record, petitioners were not liable for damages under sec. 6673. ***Solowiejczyk v. Commissioner*** 552

INVENTORIES

Commissioner's Adjustment as Abuse of Discretion—Cotton Merchant's Yearend Accrual of Liability for Unfixed On-Call Purchase Contracts—Litigation Costs.—Where in 1977 petitioners' subchapter S corporation X engaged in business of buying and selling cotton and used accrual method of accounting in reporting its income on calendar year basis; X purchased some cotton through on-call contracts, under terms of which cotton was delivered to X and provisional price paid to seller, but purchase price remained open until seller exercised his call right, fixing the price (which was tied to price of cotton futures prevailing at time of call); and, in accordance with generally accepted accounting practices and industry-wide practice, X consistently accounted for its cost of goods sold by valuing ending cotton inventory at market and accruing to cost of purchases an additional amount that would be payable by it if the cost of its unfixed, delivered, on-call purchase contracts were fixed on Dec. 31, Court determined (1) Commissioner's proposal to deny accrual under sec. 446(b) was abuse of discretion, since X's method of accounting clearly reflected its income, and (2) Tax Court was not empowered to award costs or attorneys' fees under Equal Access to Justice Act (*McQuiston v. Commissioner*, 78 T.C. 807, followed), and petitioners were not entitled to recover litigation costs or attorney fees under sec. 7430, since cases were commenced before effective date. **Molsen v. Commissioner** 485

Losses Based on Scrap Value of Materials Transferred—Sale of Inventory or Device to Circumvent Thor Holding—Retention of Dominion and Control.—Where in 1976–77 petitioner corporation X under agreements transferred its surplus and obsolete parts inventory to Y, unrelated warehouse facility; in taxable years, X sent average of 25% of its surplus and obsolete inventory to Y, and subsequently reacquired 25% of what it sent Y; and under agreements, X decided what Y could scrap, when Y could sell, and whether Y could alter inventory it acquired from X, Court sustained Commissioner's disallowance of X's claimed "loss on sale of inventory," based on scrap value of materials transferred, since transfer did not constitute a sale considering that X retained dominion and control over assets transferred for at least 4 years after initial transfer. *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, followed. **Paccar, Inc. v. Commissioner** 754

JURISDICTION
See **UNITED STATES TAX COURT**.

Page

LIMITATIONS

Assessment and Collection by Commissioner—Applicable Period—Validity of Waivers Executed by Successor in Interest to Personal Holding Company.—Commissioner was not barred from assessment and collection of deficiencies against petitioner as successor in interest to corporation X, which merged into petitioner, since 6-year statute of limitations was applicable because X, which was herein determined to be personal holding company in 1968–72, failed to attach to its returns schedule enumerating items of gross income and adjusted ordinary gross income as required by sec. 6501(f); under sec. 6501(c), consecutive consents were executed while statute of limitations was open; and under facts and applicable California law, consents were validly executed by petitioner. ***Pleasanton Gravel Co. v. Commissioner*** 839

Special Consent Extending Statutory Period—Errors on Return as "Mathematical or Clerical Error"—Timeliness of Deficiency Notice.—Where petitioners timely filed their 1978 Federal income tax return incorporating Form 4625, in which petitioners reported their sec. 57 items of tax preference; petitioners' tax return preparer misinterpreted and incorrectly reported two tax preference items, which errors were not apparent from return itself or any schedule attached to it; petitioners executed Form 872–A "Special Consent to Extend the Time to Assess Tax," on Jan. 20, 1982, with certain restriction on subject matter and scope; and statutory notice was mailed on April 14, 1983, Court determined (1) errors on return did not constitute "mathematical or clerical error appearing on the return" within meaning of sec. 6213(f)(2); and (2) errors on return were of type encompassed within limited extension of statute of limitations granted by petitioner, so that deficiency notice was timely. ***Adler v. Commissioner*** 535

LOSSES

See also **DEDUCTIONS, INVENTORIES,** and **PARTNERSHIPS.**

Commodity Tax Straddles—Sham Transactions—Applicability of Sec. 108 of Tax Reform Act of 1984.—Where, through advice and assistance of American corporation X, petitioners opened accounts with London commodity brokerage firm Y and its successor Z, by executing trading authorization giving Y discretionary authority to manage accounts, including authority to buy or sell "commodities, commodities forward contracts, and/or commodities futures contracts, on margin or otherwise"; Y entered transactions on behalf of petitioners, structured in form of inter-commodity straddles in gold and platinum; and on their 1980 and 1981 individual income tax returns petitioners claimed either ordinary or capital losses relative to straddle transactions, and adviser fee deductions for payments to X, Court determined (1) neither losses nor advisory fee deductions

LOSSES—continued

claimed by petitioners were allowable, since transactions were factual shams, designed and executed by Y and Z with participation of X, for sole purpose of achieving losses; (2) result was not changed by sec. 108 of Tax Reform Act of 1984, since that section is inapplicable to alleged straddles which are in fact fake or fictitious (*Miller v. Commissioner*, 84 T.C. 827, followed); and (3) additions to tax for negligence under sec. 6653(a) against four petitioners for 1980 were upheld. ***Forseth v. Commissioner*** 127

Forward Contracts for Purchase and Sale of Ginnie Maes and Freddie Macs—Sham Transactions—Related Fees, Additions to Tax, and Damages.—Where in 1979–81 petitioners claimed deductions for fees and under sec. 165(c)(2) for fees and losses relating to forward contracts for purchase or sale of Ginnie Maes and Freddie Macs, Court determined (1) losses were not allowable, since contracts and related transactions were factual shams which were inspired, designed, and executed by promoter and two corporations controlled by him for sole purpose of attempting to achieve tax losses for their investors; (2) fees paid to promoter to participate in program were disallowed as personal expenditures; and (3) one of petitioners was liable for addition to tax under sec. 6653(a) for negligence or intentional disregard of rules or regulations, since he knew or should have known that transactions were shams; and (4) damages under sec. 6673 were not imposed, since before publication of this opinion, petitioners were not aware that Court would consider doing so in such factual situations. ***Brown v. Commissioner*** 968

NET OPERATING LOSS

See **CONSOLIDATED RETURNS** and **DEDUCTIONS**.

NONRESIDENT ALIENS

Capital Gains and Imputed Interest From Sale of Stock After Expatriation—U.S.-Canada Tax Treaty.—Where petitioner moved to Canada on Nov. 20, 1978, renounced his U.S. citizenship on Nov. 24, and sold his entire stock interest in U.S. corporation on Dec. 1 in exchange for promissory note payable over 20 years and providing for no interest charges as long as payments on note were timely made, Court (1) granted petitioner's motion for summary judgment as to capital gains issue, since art. VIII of 1942 U.S.-Canada Convention on Double Taxation, 56 Stat. 1399, T.S. No. 983, does not allow United States to tax former citizens on gain from sale or exchange of capital assets under sec. 877, which was designed to prevent tax-motivated expatriation; and (2) denied motion as to imputed interest issue, since petitioner was liable for tax on imputed interest income under sec. 483, at 15% rate prescribed in art. XI(1) of tax treaty. ***Crow v. Commissioner*** 376

PARTNERSHIPS
See also **UNITED STATES TAX COURT**.

Oil and Gas—Limited Partners' Losses—Limited to Amounts at Risk.—Where petitioners, who were limited partners in similar oil and gas drilling partnerships, made cash contributions, and were subject to make future cash contributions if called upon by general partners to satisfy 15-year recourse notes of their partnerships, claimed their proportionate shares of losses up to the amounts of their cash contributions plus their shares of the partnership recourse notes, Court determined the deduction allowable to each petitioner for his distributive share of partnership loss was limited to the actual cash contribution to his partnership as of the close of the taxable year, since under sec. 465, each petitioner was at risk only to extent of actual cash contribution and not for his proportionate share of partnership's note. ***Pritchett v. Commissioner*** 580

Optional Basis Adjustment—Sec. 754 Election Statement Required—Foreign Partnership.—Where petitioner corporation with taxable year ending June 30 purchased one-third limited partnership interest in German partnership A, effective Jan. 1, 1973; as required by German law, A increased petitioner's basis in partnership assets and allocated excess of purchase price among A's assets owned as of Jan. 1, 1973; A carried on no trade or business within United States and derived no income from United States; and neither petitioner nor A filed either U.S. partnership return Form 1065 or sec. 754 election statement for stepped-up treatment under sec. 743(b); and petitioner reported on its corporate tax return for fiscal 1974 its distributive share of income from A, which was computed using stepped-up basis in partnership assets for depreciation purposes attaching to each corporate return untranslated copies of A's German partnership tax return and schedules for A's calendar year 1973, Court determined required election which would have permitted petitioner to benefit from adjustments to basis under secs. 754 and 743 was not made. ***Atlantic Veneer Corp. v. Commissioner***.. 1075

Purchase of Apartment Complex as Sham Transaction–No Bona Fide Business Activity—No Pass-Through of Deductions to Limited Partners.—Where individual petitioners were limited partners in petitioner X, a limited partnership; X purportedly purchased an apartment complex from Cayman Islands corporation Y, which purportedly purchased the property from Z partnership; X purportedly made interest payments to Y; and partners were subsequently "cashed out" by Z for the amount of their capital contributions plus 10% per annum simple interst, Court determined (1) X was not engaged in bona fide business activity sufficient to pass through any deductions to limited partners, since under facts and circumstances surrounding alleged sale transactions, purported sales were shams in substance for tax purposes, and (2) X was not liable for 30% withholding tax under sec. 1442 or for addition to tax under sec.

Page

PARTNERSHIPS—continued
6651(a) for failure to file a return, since purported interest payments by X were in reality the mere shifting by Z of funds under its dominion and control. ***Falsetti v. Commissioner*** 332

PENALTIES
See also **ADDITIONS TO TAX** and **LOSSES**.

Damages Assessable for Instituting Proceedings Merely for Delay—Constitutionality of Sec. 6673—Charitable Contributions.—Where petitioner claimed charitable contribution deductions for 1979–82 to Universal Life Church, Court determined claimed charitable contributions were properly disallowed, since petitioner failed to carry burden of proof that contributions were made; and Court awarded damages to United States under sec. 6673, since petitioner's claim was frivolous and without merit, and award of damages was no infringement upon petitioner's First Amendment rights. ***Bell v. Commissioner*** 436

PENSION PLANS
See **EMPLOYEES' TRUSTS**.

PERSONAL HOLDING COMPANY

Definition—Payments by Shareholder for Sand and Gravel—Rent or Royalties.—Where in taxable years 1968–72, corporation X (which subsequently merged into petitioner) received payments from Y company, which owned all of X's stock, under agreement for removal of sand and gravel from X's land, Court determined payments were not excludable from personal holding company income under sec. 543(a)(6), since considering legislative history, phrase containing word "compensation" refers exclusively to rents, and on facts and under case law, payments were not rent but constituted mineral royalties includable in personal holding company income under sec. 543(a)(3). ***Pleasanton Gravel Co. v. Commissioner*** 839

RETURNS
See **CORPORATIONS** and **LIMITATIONS**.

TRANSFEREES

Liability as—Coexecutor and Beneficiary of Estate—Binding Effect of Waiver of Restrictions on Assessment and Collection.—Where decedent's two sons, A (petitioner) and B, were coexecutors of her estate; A received deficiency notice as a fiduciary and beneficiary of the estate; A's liability was based on transfer without consideration of property from the estate which rendered the estate insolvent; prior to issuance of deficiency notice, B, but not A, executed waiver of restrictions on assessment and collection of estate tax (Form 890); absent waiver, notice would have been issued after expiration of

TRANSFEREES—continued
period for assessment; and parties filed cross motions for summary judgment, Court, having rejected petitioner's arguments as to binding effect of Form 890, determined that Commissioner made requisite showing that there was no genuine issue of material fact as to A's liability as transferee under sec. 6901(a)(1)(A)(ii), so that Commissioner's motion for summary judgment was granted. ***Ewart, Fiduciary and Transferee v. Commissioner*** 544

UNITED STATES TAX COURT
See also **ESTATE TAX**.

Commissioner's Motion for Partial Summary Judgment—Jurisdiction—Issue of Nonreceipt of Tax Refund Checks.—Where petitioner alleged that refund checks issued by Commissioner were misappropriated by petitioner's attorney; deficiency computation took into account refunds issued to petitioner; and Commissioner filed motion for partial summary judgment on premise that Court does not have jurisdiction to consider question of whether amount of deficiency should reflect refunds issued by Commissioner and not received by petitioner, Court denied motion, since Court has jurisdiction to consider issue in determination of a deficiency or overpayment. ***Naftel v. Commissioner*** 527

Commissioner's Motion for Production of Books and Records—Foreign Corporation—Order Reflecting Terms Agreed Upon by Parties.—Where petitioner, Hong Kong corporation, filed U.S. income tax returns of a foreign corporation in 1974–76; and Commissioner disallowed certain interest and home office administrative deductions for lack of substantiation on the grounds that Commissioner's agents had been denied access to petitioner's original books and records in Hong Kong, Court granted Commissioner's motion for production of petitioner's books and records, applying criteria for scope of a sec. 7456(b) order as set forth in *United States v. Powell*, 379 U.S. 48, and issuing order reflecting terms agreed upon by parties. ***Hong Kong & Shanghai Banking Corp. v. Commissioner*** 701

Commissioner's Motion for Summary Judgment as to Deficiencies and Fraud Additions—Petitioner's Failure To Respond to Requests for Admissions—Allegations Deemed Admitted Under Rule 90(c) Sufficient To Satisfy Commissioner's Burden of Proof.—Where petitioners failed to respond to Commissioner's requests for admissions, Court granted Commissioner's motion for summary judgment as to income tax deficiencies and as to additions to tax for fraud under sec. 6653(b), since allegations contained in request for admissions were deemed admitted under Rule 90(c) and were sufficient to satisfy Commissioner's burden of proving (1) that no genuine issue of material fact existed as to deficiency determinations and that Commissioner was entitled to decision with respect to deficiency determinations as matter of law and (2) that some portion

Page

UNITED STATES TAX COURT—continued

of understatement of income for each year was due to fraud with intent to evade tax. ***Marshall* v. *Commissioner*** 267

Commissioner's Motions To Dismiss for Lack of Jurisdiction—Petition for Judicial Review of Final Partnership Administrative Adjustments—Partner's Capacity To File as Tax Matters Partner or Notice Partner.—Where Commissioner filed motions to dismiss petitions of 2 limited partnerships for judicial review of final partnership administrative adjustments on ground that petitioner as tax matters partner failed to file timely petitions within 90 days required by sec. 6226(a), Court denied Commissioner's motions and determined that petitions filed on 95th day were valid, since petitioner was both the tax matters partner and a notice partner as defined in sec. 6231(a)(7) and (8), respectively, and was qualified to file petitions within 90-day period of sec. 6226(a) or within 60-day period after 90-day period under sec. 6226(b); and Court denied petitioner's motion to amend petition and change caption, since other partners could participate in action by filing appropriate election notices under Rule 244(b). ***Barbados #6 Ltd.* v. *Commissioner*** 900

Petitioner's Motions for Extension of Time To Answer Requests for Admission, To Withdraw Admissions, and for a Protective Order—Commissioner's Motions for Summary Judgment and To Compel Responses to Interrogatories and To Compel Production of Documents or To Impose Sanctions—Promoter of Tax Shelter Program.—Where in 1977–79 petitioner promoted and sold tax shelter program utilizing foreign trust organizations, and Commissioner determined that he had failed to pay tax on substantial amounts of income earned from sale of program and that all or part of underpayment was due to fraud, Court denied petitioner's motions (1) to enlarge time in which to answer Commissioner's requests for admission, since requests were deemed admitted under Rule 90(c) and motion was untimely, (2) to withdraw or modify deemed admissions, since criteria under Rule 90(e) were not satisfied, and (3) for a protective order requesting Court to limit discovery to 1979, since discovery requests were relevant, and statute of limitations does not run on fraudulent return; and Court granted Commissioner's motion to compel responses to interrogatories and to compel production of documents or to impose sanctions under Rule 104(c), since it was not based on grand jury materials, but denied Commissioner's motion for summary judgment under Rule 121, since admitted facts did not support conclusory facts upon which Commissioner relied. ***Dahlstrom* v. *Commissioner*** 812

Petitioner's Motion for Relief From Agreement To Be Bound by Result in Other Cases—Counsel's Authority and Conflict of Interest—No Cognizable Prejudice.—Where former counsel had agreed that petioners would be bound by result in *Anderson v. Commissioner*, 83 T.C. 898, involving issue herein, and petitioners

UNITED STATES TAX COURT—continued
moved to be relieved of agreement on grounds that counsel was not authorized to make agreement and had a conflict of interest violative of A.B.A. Code of Professional Responsibility, by reason of prior representation of promoter of tax shelter in which petitioners had invested, Court denied petitioner's motion, since on evidence showing agreement was consistent with strategy chosen by petitioner and counsel, counsel had actual and apparent authority to enter agreement, there was no conflict of interest considering that tax positions of parties represented by counsel were parallel, if not identical, and under criteria in rule 16, Fed. R. Civ. P., for ruling on motion, there was no injustice in holding petitioners to agreement because petitioners failed to show any cognizable prejudice, ***Adams v. Commissioner*** 359

Petitioners' Motion for Recovery of Litigation Costs—"Prevailing Party" Requirements—Commissioner's Position Made Reasonable by Petitioners' Silence and Surprise Testimony.—Where no deficiencies or additions to tax were found at trial, and petitioners filed motion for recovery of litigation costs under Rule 231 and sec. 7430, Court denied motion, since petitioners failed to satisfy sec. 7430(c)(2) "prevailing party" definition, because fact that petitioners prevailed at trial on cash hoard defense did not establish unreasonableness of Commissioner's position, and their strategy of silence and surprise testimony had effect of making Commissioner's position reasonable until testimony was received. ***DeVenney v. Commissioner*** 927

Petitioners' Motion To Seal Court Record—Country Music Star—Annoyance, Embarrassment, or Oppression vs. Public Interests.—Where petitioners, nationally known country music star and his wholly owned music company, moved for protective order under Rule 103(a) to seal entire record (including, but not limited to, all pleadings, depositions, exhibits, papers, and filings), to prevent annoyance, embarrassment, and oppression, Court denied motion, since petitioners demonstrated no probative evidence of good cause sufficient to outweigh public interests. ***Willie Nelson Music Co. v. Commissioner*** 914

VALUATION
See also **CAPITAL EXPENDITURES, CONTRIBUTIONS,** and **GIFTS.**

Overstatements of Charitable Deduction—Interest Rate on Substantial Underpayments Attributable to Tax Motivated Transactions—Tax Court's Application of Sec. 6621(d).—Where petitioners purchased Indian artifacts and etchings and donated all the artifacts and about two-fifths of the etchings to qualified charitable organization after holding them for required capital gain period, Court determined Commissioner's valuation of donated items reflect-

Page

VALUATION—continued

ed fair market value as of dates of donation, since testimony of Commissioner's expert witnesses was credible, pattern of abuse designed to achieve excessive valuations of donated items was evident, and donated items were grossly overvalued; and Court, on its own motion, applied sec. 6621(d), which provides for increase in interest rate on underpayments where there is a substantial underpayment attributable to tax-motivated transactions. ***Johnson v. Commissioner*** 469

AMENDMENTS
to
RULES OF PRACTICE AND PROCEDURE
of the
UNITED STATES TAX COURT

Rules 3, 10, 13, 20, 25, 33, 70, 71, 90, 104, 134, 140, 143, 151, 175, and 182 of the Rules of Practice and Procedure of the United States Tax Court are amended as hereinafter set forth.

The Notes accompanying these amendments were prepared by the Rules Committee and are included herein for the convenience of the Bar. They are not officially part of the Rules and are not included in the printed publication prepared for general distribution.

TITLE I

SCOPE OF RULES; CONSTRUCTION; EFFECTIVE DATE; DEFINITIONS

RULE 3. DEFINITIONS

(a) - (c) [Not changed]
(d) Special Trial Judge: The term Special Trial Judge as used in these Rules refers to a judicial officer appointed pursuant to Section 7456(c) of the Code. See Rule 180.

Note

Par. (d) of Rule 3 has been amended to reflect that the title "commissioner" formerly used in Code Section 7456(c) has been changed to "special trial judge." See Section 464 of the Tax Reform Act of 1984, Public Law 98–369, 98 Stat. 494, 824–825 (July 18, 1984).

TITLE II

THE COURT

RULE 10. NAME, OFFICE, AND SESSIONS

(a) - (d) [Not changed]
(e) Mailing Address: Mail to the Court should be addressed to the United States Tax Court, 400 Second Street, N.W., Washington, D.C. 20217. Other addresses, such as locations at which the Court may be in session, should not be used, unless the Court directs otherwise.

Note

Par. (e) of Rule 10 has been amended to provide that the Court may direct that mail be addressed to locations other than the Court in Washington. The amendment is effective January 2, 1985.

RULE 13. JURISDICTION

(a) - **(c)** [Not changed]

(d) Contempt of Court: Contempt of Court may be punished by fine or imprisonment within the scope of Code Section 7456(e).

Note

Par. (d) of Rule 13 has been amended to reflect that former subsection (d) of Code Section 7456 has been redesignated as subsection (e). See Section 106(c)(2) of the Miscellaneous Revenue Act of 1982, Public Law 97-362, 96 Stat. 1726, 1730 (Oct. 25, 1982).

TITLE III

COMMENCEMENT OF CASE; SERVICE AND FILING OF PAPERS; FORM AND STYLE OF PAPERS; APPEARANCE AND REPRESENTATION; COMPUTATION OF TIME

RULE 20. COMMENCEMENT OF CASE

(a) [Not changed]

(b) Filing Fee: At the time of filing a petition, a fee of $60 shall be paid. The payment of any fee under this paragraph may be waived if the petitioner establishes to the satisfaction of the Court by an affidavit containing specific financial information that he is unable to make such payment.

Note

Rule 20(b) has been amended to require a fee of $60 for the commencement of any case before the Court. Formerly, a fee of only $10 was required if the petitioner elected to have the case treated as a small tax case. The amendment applies to cases commenced after April 30, 1985. Petitioners who are unable to pay the $60 filing fee may request a waiver of the fee.

RULE 25. COMPUTATION OF TIME

(b) District of Columbia Legal Holidays: The legal holidays within the District of Columbia, in addition to any other day appointed as a holiday by the President or the Congress of the United States, are as follows:

New Year's Day—January 1

Birthday of Martin Luther King, Jr.—Third Monday in January

[No other changes in holidays]

Note

Par. (b) of Rule 25 has been amended to reflect the enactment of Public Law 98–144, 97 Stat. 917 (1983), designating the birthday of Martin Luther King, Jr., the third Monday in January, a legal public holiday. The amendment is effective January 1986.

TITLE IV

PLEADINGS

RULE 33. SIGNING OF PLEADINGS

(a) [Not changed]

(b) Effect of Signature: The signature of counsel or a party constitutes a certificate by him that he has read the pleading; that to the best of his knowledge, information, and belief formed after reasonable inquiry, it is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and that it is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation. The signature of counsel also constitutes a representation by him that he is authorized to represent the party or parties on whose behalf the pleading is filed. If a pleading is not signed, it shall be stricken, unless it is signed promptly after the omission is called to the attention of the pleader. If a pleading is signed in violation of this Rule, the Court, upon motion or upon its own initiative, may impose upon the person who signed it, a represented party, or both, an appropriate sanction, which may include an order to pay to the other party or parties the amount of the reasonable expenses incurred because of the filing of the pleading, including reasonable counsel's fees.

Note

The amendment to par. (b) of Rule 33 is derived from the 1983 amendment to Rule 11 of the Federal Rules of Civil Procedure. It is designed to emphasize the responsibilities of counsel and deter dilatory and abusive tactics by imposing effective sanctions therefor. The amendment imposes upon counsel the duty to make reasonable inquiry as to both the facts and the law prior to the filing of any pleading. The standard is one of reasonableness under the circumstances. What constitutes a reasonable inquiry may depend on such factors as how much time for investigation was available to the signer; whether he had to rely on a client for information as to the underlying facts; whether the pleading was based on a plausible view of the law; or whether he depended on forwarding counsel or another member of the bar. Although the Rule as amended also applies to unrepresented parties, the Court has discretion to take into account the special circumstances that may arise in *pro se* situations.

The provision in former Rule 33(b) regarding the striking of pleadings and of scandalous or indecent material has been stricken. Such problems may be dealt with under Rule 52.

The requirements of amended Rule 33(b) with respect to signing of pleadings are equally applicable to motions. See Rule 50(a).

The amendment is effective July 1, 1986.

TITLE VII

DISCOVERY

RULE 70. GENERAL PROVISIONS

(a) [Not changed]

(b) Scope of Discovery: (1) The information or response sought through discovery may concern any matter not privileged and which is relevant to the subject matter involved in the pending case. It is not ground for objection that the information or response sought will be inadmissible at the trial, if that information or response appears reasonably calculated to lead to discovery of admissible evidence, regardless of the burden of proof involved. If the information or response sought is otherwise proper, it is not objectionable merely because the information or response involves an opinion or contention that relates to fact or to the application of law to fact. But the Court may order that the information or response sought need not be furnished or made until some designated time or a particular stage has been reached in the case or until a specified step has been taken by a party.

(2) The frequency or extent of use of the discovery methods set forth in paragraph (a) shall be limited by the Court if it determines that: (i) the discovery sought is unreasonably cumulative or duplicative, or is obtainable from some other source that is more convenient, less burdensome, or less expensive; (ii) the party seeking discovery has had ample opportunity by discovery in the action to obtain the information sought; or (iii) the discovery is unduly burdensome or expensive, taking into account the needs of the case, the amount in controversy, limitations on the parties' resources, and the importance of the issues at stake in the litigation. The Court may act upon its own initiative after reasonable notice or pursuant to a motion under Rule 103.

(c) - **(d)** [Not changed]

(e) Signing of Discovery Requests, Responses, and Objections: (1) Every request for discovery or response or objection thereto made by a party represented by counsel shall be signed by at least one counsel of record. A party who is not represented by counsel shall sign the request, response, or objection. The signature shall conform to the requirements of Rule 23(a)(3). The signature of counsel or a party constitutes a certification that he has read the request, response, or objection, and that to the best of his knowledge, information, and belief formed after a reasonable inquiry, it is (i) consistent with these Rules and warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law; (ii) not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation; and (iii) not unreasonable or unduly burdensome or expensive, given the needs of the case, the discovery already had in the case, the amount in controversy, and the importance of the issues at stake in the litigation. If a request, response, or objection is not signed, it shall be stricken, unless it is signed promptly after the omission is called to the attention of the party making the request, response, or objection, and a party shall not be obligated to take any action with respect to it until it is signed.

(2) If a certification is made in violation of this Rule, the Court, upon motion or upon its own initiative, may impose upon the person who made the certification, the party on whose behalf the request, response, or objection is made, or both, an appropriate sanction, which may include an order to pay the amount of the reasonable expenses incurred because of the violation, including reasonable counsel's fees.

(f) Other Applicable Rules: For Rules concerned with the frequency and timing of discovery in relation to other procedures, supplementation of answers, protective orders, effect of evasive or incomplete answers or responses, and sanctions and enforcement action, see Title X.

Note

A new subpar. (2) has been added to Rule 70(b). The amendment is intended to guard against discovery that is redundant or disproportionate to the amount of money or the importance of the issues at stake by giving the Court authority to reduce the amount of discovery of matters that otherwise are proper subjects of discovery. The amendment is derived from the 1983 amendment to Rule 26(b) of the Federal Rules of Civil Procedure.

A new par. (e) also has been added to Rule 70, requiring that every discovery request, response, or objection be signed by counsel or the party. It also is derived from the 1983 amendment to Rule 26 of the Federal Rules of Civil Procedure, which added a new paragraph (g). The certification requirement of Rule 70(e) is intended to deter both excessive discovery and evasion or resistance to reasonable discovery requests by requiring the party or counsel to make reasonable inquiry into the factual and legal basis for his request, response, or objection, as well as to consider the reasonableness thereof. The latter requirement compels the party or counsel to weigh the need for discovery in a particular case against the cost and other burdens thereof.

The duty to make a "reasonable inquiry" is satisfied if the inquiry that is made is reasonable under the circumstances. The standard is an objective one similar to that under Rule 33.

Former par. (e) of Rule 70 has been redesignated as par. (f).

The amendment is effective July 1, 1986.

RULE 71. INTERROGATORIES

(d) Experts: (1) [Not Changed]

(2) For provisions regarding the submission and exchange of expert witness reports, see Rule 143(f).

Note

Par. (d) (2) of Rule 71 has been amended to delete provisions regarding submission and exchange of expert witness reports. Those provisions, as amended, are now set forth in Rule 143(f). The amendment is effective July 1, 1986.

TITLE IX

ADMISSIONS AND STIPULATIONS

RULE 90. REQUESTS FOR ADMISSION

(a) - (b) [Not changed]

(c) Response to Request: Each matter is deemed admitted unless, within 30 days after service of the request or within such shorter or longer time as the Court may allow, the party to whom the request is directed serves upon the requesting party (1) a written answer specifically admitting or denying the matter involved in whole or in part, or asserting that it cannot be truthfully admitted or denied and setting forth in detail the reasons why this is so, or (2) an objection, stating in detail the reasons therefor. The response shall be signed by the party or his counsel, and the original thereof, with proof of service on the other party, shall be filed with the Court. A denial shall fairly meet the substance of the requested admission; and, when good faith requires that a party qualify his answer or deny only a part of a matter, he shall specify so much of it as is true and deny or qualify the remainder. An answering party may not give lack of information or knowledge as a reason for failure to admit or deny unless he states that he has made reasonable inquiry and that the information known or readily obtainable by him is insufficient to enable him to admit or deny. A party who considers that a matter, of which an admission has been requested, presents a genuine issue for trial may not, on that ground alone, object to the request; he may, subject to the provision of paragraph (g) of this Rule, deny the matter or set forth reasons why he cannot admit or deny it. An objection on the ground of relevance may be noted by any party but is not to be regarded as just cause for refusal to admit or deny.

(d) Effect of Signature: (1) The signature of counsel or a party constitutes a certification that he has read the request for admission or response or objection, and that to the best of his knowledge, information, and belief formed after a reasonable inquiry, it is (i) consistent with these Rules and warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law; (ii) not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation; and (iii) not unreasonable or unduly burdensome or expensive, given the needs of the case, the discovery already had in the case, the amount in controversy, and the importance of the issues at stake in the litigation. If a request, response, or objection is not signed, it shall be stricken, unless it is signed promptly after the omission is called to the attention of the party making the request, response, or objection, and a party shall not be obligated to take any action with respect to it until it is signed.

(2) If a certification is made in violation of this Rule, the Court, upon motion or upon its own initiative, may impose upon the person who made the certification, the party on whose behalf the request, response, or objection is made, or both, an appropriate sanction, which may include an order to pay the amount of the reasonable expenses incurred because of the violation, including reasonable counsel's fees.

(e) **Motion to Review:** The party who has requested the admissions may move to determine the sufficiency of the answers or objections. Unless the Court determines that an objection is justified, it shall order that an answer be served. If the Court determines that an answer does not comply with the requirements of this Rule, it may order either that the matter is admitted or that an amended answer be served. In lieu of any such order, the Court may determine that final disposition of the request shall be made at some later time which may be more appropriate for disposing of the question involved.

(f) **Effect of Admission:** Any matter admitted under this Rule is conclusively established unless the Court on motion permits withdrawal or modification of the admission. Subject to any other orders made in the case by the Court, withdrawal or modification may be permitted when the presentation of the merits of the case will be subserved thereby, and the party who obtained the admission fails to satisfy the Court that the withdrawal or modification will prejudice him in prosecuting his case or defense on the merits. Any admission made by a party under this Rule is for the purpose of the pending action only and is not an admission by him for any other purpose, nor may it be used against him in any other proceeding.

(g) **Sanctions:** If any party unjustifiably fails to admit the genuineness of any document or the truth of any matter as requested in accordance with this Rule, the party requesting the admission may apply to the Court for an order imposing such sanction on the other party or his counsel as the Court may find appropriate in the circumstances, including but not limited to the sanctions provided in Title X. The failure to admit may be found unjustifiable unless the Court finds that (1) the request was held objectionable pursuant to this Rule, or (2) the admission sought was of no substantial importance, or (3) the party failing to admit had reasonable ground to doubt the truth of the matter or the genuineness of the document in respect of which the admission was sought, or (4) there was other good reason for failure to admit.

(h) Other Applicable Rules: For Rules concerned with frequency and timing of requests for admissions in relation to other procedures, supplementation of answers, effect of evasive or incomplete answers or responses, protective orders, and sanctions and enforcements, see Title X.

Note

A new par. (d), regarding the effect of signature of a party or counsel, has been added to Rule 90. See the Note to Rule 70.

Former pars. (d), (e), (f), and (g) have been redesignated as pars. (e), (f), (g), and (h), respectively. The amendment is effective July 1, 1986.

TITLE X

GENERAL PROVISIONS GOVERNING DISCOVERY, DEPOSITIONS, AND REQUESTS FOR ADMISSION

RULE 104. ENFORCEMENT ACTION AND SANCTIONS

(a) and **(b)** [Not changed]

(c) Sanctions: If a party or an officer, director, or managing agent of a party or a person designated in accordance with Rule 74(b), 75(c), or 81(c) fails to obey an order made by the Court with respect to the provisions of Rule 71, 72, 73, 74, 75, 81, 82, 83, 84, or 90, the Court may make such orders as to the failure as are just, and among others the following:

(1) - (3) [Not changed]

(4) In lieu of the foregoing orders or in addition thereto, the Court may treat as a contempt of the Court the failure to obey any such order, and the Court may also require the party failing to obey the order or counsel advising him, or both, to pay the reasonable expenses, including counsel's fees, caused by the failure, unless the Court finds that the failure was

substantially justified or that other circumstances make an award of expenses unjust.

Note

Subpar. (4) of par. (c) of Rule 104 has been amended to authorize the Court, in its discretion, to require a party who fails to obey a Court order, or counsel advising him, or both, to pay reasonable expenses, including counsel's fees, occasioned by the failure. The amendment is derived from Rule 37(b)(2) of the Federal Rules of Civil Procedure. The amendment is effective July 1, 1986.

TITLE XIII

CALENDARS AND CONTINUANCES

RULE 134. CONTINUANCES

A case or matter scheduled on a calendar may be continued by the Court upon motion or at its own initiative. A motion for continuance shall inform the Court of the position of the other parties with respect thereto, either by endorsement thereon by the other parties or by a representation of the moving party. A motion for continuance based upon the pendency in a court of a related case or cases shall include the name and docket number of any such related case, the names of counsel for the parties in such case, and the status of such case, and shall identify all issues common to any such related case. Continuances will be granted only in exceptional circumstances. Conflicting engagements of counsel or employment of new counsel ordinarily will not be regarded as ground for continuance. A motion for continuance, filed 30 days or less prior to the date to which it is directed, may be set for hearing on that date, but ordinarily will be deemed dilatory and will be denied unless the ground therefor arose during that period or there was good reason for not making the motion sooner. As to extensions of time, see Rule 25(c).

Note

Rule 134 has been revised to reflect a new policy toward continuances. The Rule as amended provides that continuances will be granted only in exceptional circumstances. The parties should not anticipate that the Court will grant the first requested continuance. Under the revised Rule, continuances ordinarily will not be granted on account of conflicting engagements of counsel or employment of new counsel.

The amendment also requires that a motion for continuance based upon the pendency of a related case or cases shall include certain identifying information with respect to any such related case. The amendment is effective July 1, 1986.

TITLE XIV

TRIALS

RULE 140. PLACE OF TRIAL

(a) [Not changed]

(b) Form: Such designation shall be set forth on a paper separate from the petition or answer and shall consist of an original and two copies. See Form 4, Appendix I.

(c) [Not changed]

Note

Rule 140(b) has been amended to delete the provision that the designation of place of trial satisfy the requirements of form applicable to motions. The amendment also provides that such designation shall be separately stated. The amendment is effective July 1, 1986.

RULE 143. EVIDENCE

(a) - **(e)** [Not changed]

(f) Expert Witness Reports: (1) Unless otherwise permitted by the Court upon timely request, any party who calls an expert witness shall cause that witness to prepare a written report for submission to the Court and to the opposing party. The report shall set forth the qualifications of the expert witness and shall state his opinion and the facts or data on which that opinion is based. The report shall set forth in detail the reasons for the conclusion, and it will be marked as an exhibit, identified by the witness, and received in evidence as the direct testimony of the expert witness, unless the Court determines that he is not qualified as an expert. Additional direct testimony with respect to the report may be allowed to clarify or emphasize matters in the report, to cover matters arising after the preparation of the report, or otherwise at the discretion of the Court. If not furnished earlier, each party who calls any expert witness shall furnish to each other party, and shall submit to the Court, not later than 15 days prior to the call of the trial calendar on which the case shall appear, a copy of all expert witness reports prepared pursuant to this subparagraph. An expert witness' testimony will be excluded altogether for failure to comply with the provisions of this paragraph, unless the failure is shown to be due to good cause and unless the failure does not unduly prejudice the opposing party, such as by significantly impairing his ability to cross-examine the expert witness or by denying the opposing party the reasonable opportunity to obtain evidence in rebuttal to the expert witness' testimony.

(2) The Court ordinarily will not grant a request to permit an expert witness to testify without a written report where the expert witness' testimony is based on third-party contacts, comparable sales, statistical data, or other detailed, technical information. The Court may grant such a request, for example, where the expert witness testifies only with respect to industry practice or only in rebuttal to another expert witness.

Note

Par. (f) of Rule 143 has been amended to include provisions regarding the submission and exchange of expert witness reports. The Rule generally requires all expert witnesses to prepare a written report for submission to the Court and to the opposing party. The Court, in its discretion, may permit otherwise. The Rule requires that the report set forth in detail the reasons for the expert's conclusion. The report will be marked as an exhibit, identified, and received in evidence as the direct testimony of the expert witness, unless the Court determines that he is not qualified as an expert. Under the Rule, the Court may allow additional direct testimony with respect to the report to clarify or emphasize matters in the report, or as to new developments, or at the discretion of the Court. The Rule also requires each party to furnish to each other party and to submit to the Court, not later than 15 days prior to the call of the calendar, a copy of all expert witness reports. The Court will exclude an expert witness' testimony for failure to comply with the Rule, unless: (1) such failure is shown to be due to good cause; and (2) such failure will not cause the opposing party undue prejudice, for example, by significantly impairing his ability to cross-examine the expert or denying him the reasonable opportunity to obtain rebuttal evidence.

A party who wishes to be excused from the requirement of the Rule with respect to preparation and submission of a written report must request the permission of the Court. If such a request is granted, the Court may impose such terms and conditions as it sees fit; for example, the Court may require counsel or the party to furnish to each other party and to submit to the Court a brief statement describing the opinion that the expert witness is expected to render at trial.

The amendment is effective July 1, 1986.

RULE 151. BRIEFS

(b) Time for Filing Briefs: Briefs may be filed simultaneously or seriatim, as the presiding Judge directs. The following times for filing briefs shall prevail in the absence of any different direction by the presiding Judge:

(1) *Simultaneous Briefs:* Opening briefs within 75 days after the conclusion of the trial, and answering briefs 45 days thereafter.

(2) *Seriatim Briefs:* Opening brief within 75 days after the conclusion of the trial, answering brief within 45 days thereafter, and reply brief within 30 days after the due date of the answering brief.

A party who fails to file an opening brief is not permitted to file an answering or reply brief except on leave granted by the Court. A motion for extension of time for filing any brief shall be made prior to the due date and shall recite that the moving party has advised his adversary and whether or not he objects to the motion. As to the effect of extensions of time, see Rule 25(c).

Note

Par. (b) of Rule 151 has been amended to extend the time for filing briefs. The amendment is intended in part to discourage requests for extensions of time to file briefs by providing ample time for filing. The amendment is effective September 1, 1985.

TITLE XVII

SMALL TAX CASES*

RULE 175. PLEADINGS

(a) Petition: (1) *Form and Content:* [Not changed]

(2) *Filing Fee:* The fee for filing a petition shall be $60, payable at the time of filing. The payment of any fee under this paragraph may be waived if the petitioner establishes to the satisfaction of the Court by an affidavit containing specific financial information that he is unable to make such payment.

Note

Rule 175(a)(2) has been amended to require a fee of $60 for the commencement of a small tax case. See Note to Rule 20(b).

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*The maximum amount of the deficiency in dispute, for a taxable or calendar year, has been increased from $5,000 to $10,000, effective July 18, 1984. See Section 461 of the Tax Reform Act of 1984, Public Law 98-369 (July 18, 1984).

TITLE XVIII

SPECIAL TRIAL JUDGES*

RULE 182. CASES INVOLVING $10,000 OR LESS

Except as otherwise directed by the Chief Judge, the following procedure shall be observed in small tax cases (as defined in Rule 171) and in all other cases where neither the amount of the deficiency placed in dispute (within the meaning of Code Section 7463), nor the amount of any claimed overpayment, exceeds $10,000:

(a) and **(b)** [Not changed]

(c) Decision: The Chief Judge may authorize the Special Trial Judge to make the decision of the Court in any small tax case (as defined in Rule 171) and in any other case where neither the amount of the deficiency placed in dispute (within the meaning of Code Section 7463), nor the amount of any claimed overpayment, exceeds $10,000, subject to such conditions and review as the Chief Judge may provide.

Note

Par. (c) of Rule 182 has been amended to provide that the Chief Judge may authorize the Special Trial Judge to make the decision of the Court in any small tax case and in any other case where neither the amount of the deficiency in dispute nor the amount of any claimed overpayment exceeds $10,000, subject to such conditions and review as the Chief Judge may provide. The amendment is intended to make clear that the Chief Judge may authorize the Special Trial Judge to make the decision of the Court in cases where no trial is held, for example, in cases submitted under Rule 122 and in cases disposed of by motion, provided the dollar limits set forth above are satisfied. The amendment is effective January 16, 1984.

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*The maximum amount of the deficiency in dispute, for a taxable or calendar year, in cases in which the Special Trial Judges are authorized to make the decisison of the Court, has been increased from $5,000 to $10,000, effective October 25, 1982. See Section 463 of the Tax Reform Act of 1984, Public Law 98-369 (July 18, 1984).

TITLE XXI

DECLARATORY JUDGMENTS*

[No change in Rules in this Title]

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*Code Section 7477, which provided for declaratory judgments with respect to transfers of property from the United States, has been repealed. The repeal applies generally to transfers or exchanges after December 31, 1984, in tax years ending after such date, but such repeal does not apply to any transfer or exchange of property described in a request filed before March 1, 1984, under Code Section 367(a). Section 131(e)(1), (g)(1) and (3), Tax Reform Act of 1984, Public Law 98-369, 98 Stat. 494, 664-665 (July 18, 1984).

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